Regulation

Summer 1990 The Cato Review of Business & Government

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Broader Medical Insurance

Simon Rottenberg

Changes in Pension Regulation

Kathleen P. Utgoff

Warning of Plant Closures

Ronald G. Ehrenberg and George H. Jakubson

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The Excluded Americans by William Tucker. Tucker examines the problem of homelessness as a true investigative reporter should—both by camping out with the homeless in Grand Central Station and by analyzing the data of the social scientists. He concludes that homelessness is largely the result of rent control and zoning policies. A Regnery Gateway book. 1990/256 pp./$17.95 cloth

The Politics of Plunder by Doug Bandow. In this collection of columns on policy issues ranging from agricultural subsidies to gay rights, Bandow shows how politicians and bureaucrats have failed to respect the Founding Fathers' intent to create a government of limited powers. 1990/507 pp./$34.95 cloth

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Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Transcending Cost-Benefit Calculus

TO THE EDITOR:

Your Winter 1990 issue excoriates recent environmental coverage by the major newsmagazines, contending among other things that I wrote ("Cleaning Up Our Mess," *Newsweek*, July 21, 1989) that environmental issues have passed "beyond benefit-cost analysis." You further complain that any "decent respect for the facts" would have led me to mention three things: that the ecosphere itself is not in danger of destruction, that market-based environmental remedies may be preferable to traditional regulation, and that environmental benefits must be weighed against cost.

Actually what I wrote was that environmental protection "transcend[s] cost-benefit calculations." Further, points one and two of your inventory were not only mentioned by *Newsweek*, but prominently so. The entire first page of my cover story was devoted to the reasons for believing that the ecosphere itself is not threatened: the first two sentences of the article read, "In the aftermath of events like the Exxon Valdez oil spill, every reference to the environment is prefaced with the adjective 'fragile.' Nothing could be further from the truth." Later in the text, I defended emissions trading as a market-based control mechanism for air pollution.

Your misquote of me was small, but had the compensating virtue of also being somewhat out of context. The full sentence asserts that environmental protection "transcends cost-benefit calculation" *because it is a social good.*

As *Regulation* knows, classical liberal democratic philosophy has long held that some social goods—personal and property rights, freedoms of religion and conscience, etc.—ought to be safeguarded regardless of how they affect the calculus of productive efficiency.

It may be perfectly fair to use cost-benefit analysis as, say, the tool for judging certification of a new drug that would help a large number of people while injuring a tiny number. In a context like that it might be entirely proper for policymakers coldly to weigh health gains and avoided health-care expenses against likely litigation costs and compensatory payments to the injured. Numbers along these lines can generally be derived with reasonable accuracy, so that policy decisions stand a good chance of being rational; whether or not to sanction any particular pharmaceutical has no larger meaning to society; and if an error occurs, a bad drug can be withdrawn from the market very rapidly, leaving no harmful legacy.

Protection of the ecology differs from this kind of cost-benefit test in all three respects.

First, numbers are difficult to derive accurately. Historically, cost estimates for pollution abatement have usually been far higher than actual expenditures, because estimates are based on technology existing at the time a regulation is passed—before there exists a market incentive to innovate. Environmental benefits are hard to project because in the case of most health degradation it is nearly impossible to know whether any given person or group would or would not have gotten sick had the environment been cleaner. Even tightly controlled clinical trials rarely succeed in isolating specific environmental exposure factors. Nor is there any rational way to assign benefit value to the beauty of nature, the life-quality enrichment that comes from having wilderness preserves and parks, and so on.

Environmentalism, meanwhile, bears on shared values. Other things being equal, society ought to preach conservation over waste; cleanliness over carelessness; respect for whoever's property is downriver or downwind.

Finally, damaging the environment may be irresponsible to our descendents who cannot have a voice in current policymaking, but whose interests should be high in our minds notwithstanding. Of course environmentalists exaggerate by pretending that pollution is irreversible; the ecosphere of Earth has shrugged off far worse than humanity has thrown at it. But such corrections happen over geologic time, and may be unpleasant for living things in the interim. Why, if we respect our children's prospects, take any avoidable risk of rendering their lives ecologically imperiled, or even unpleasant?

The proper test for environmental regulation should not be cost-benefit analysis but reasonableness. I know economists blanch at that term, because it engages subjective human emotions and does not translate well into bar graphs. But that's real life, and real life cannot be assumed away with a model.

Huge expenditures for infinitesimal environmental gains do not pass a reasonableness test. This is why, for example, *Newsweek* advocated that Congress abandon such quixotic goals as lowering cancer risks at the factory gate to below one in a million, in favor of more pragmatic emissions control systems like performance standards. But many environmental improvements can be achieved at reasonable cost and will contribute mightily to the social good.

Gregg Easterbrook
Contributing Editor
Newsweek
Washington, D.C.

P.S. Like the editors of *Regulation*, I too admire my competitor *Time* for its courageous declaration that "our stand on the planet is that we favor its survival." Roll over, Patrick Henry! Getting this bold policy out into the open will help *Time* make its copy even more snazzy, eliminating that annoying formality of balancing stories by quoting from peo-

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ple who do not favor the planet's survival.

NISKANEN responds:

My *one* argument with Gregg Easterbrook's fine *Newsweek* article on the environment is his conclusion that environmental protection "transcend[s] cost-benefit calculations." (My apology for the minor misquotation.) The above development of his conclusion, however, does not resolve this argument:

First, the problems of estimating the benefits and costs of environmental protection make benefit-cost analysis difficult but not irrelevant. The benefits are especially difficult to measure, but one should at least be cautioned by the failure to find *any* direct epidemiological evidence of the alleged adverse effects of a wide range of synthetic compounds already subject to regulation—including most air toxics, food additives, pesticides, and CFCs. Easterbrook is correct that the private estimates of costs are usually high, but the government estimates are usually low.

Second, a shared environmental ethic is especially important to reduce such problems as litter and graffiti, because no acceptable system of monitoring and sanctions is sufficient for this purpose. Benefit-cost analysis, however, is the primary form of reasoning that is useful to sort out whether moral suasion, a broader extension of property rights, selective taxes, or regulation is the most effective and efficient means to address specific environmental problems.

Third, some forms of pollution have long-lived effects. This presents a special problem for democratic politics, because our children are not adequately represented, but not for benefit-cost analysis. And one should also recognize that measures that reduce economic growth also have long-lived effects. The one condition that best explains both health status and environmental conditions, both over time and across countries, is the level of real per capita income. Environmental measures for which the present value of the benefits are less than the costs are likely to reduce both economic growth and the general quality of the environment.

As a substitute for benefit-cost analysis, Easterbrook proposes a standard of "reasonableness." That may be correct, but it is not very helpful. Reasonable by what criteria? Reasonable to whom? In the Lord's Prayer, we pray to "forgive us our trespasses." Pollution is a trespass. Government regulation is also a trespass. Neither has any moral sanction. Our moral challenge is to reduce some weighted sum of the harm that we inflict on others. And, until someone has a better idea, careful benefit-cost analysis is probably the best way to meet that challenge.

W.N.

Toothpaste, Rap, and Clean Air

TO THE EDITOR:

The resistance of most market-oriented analysts to applying to environmental issues the principles they apply elsewhere in the economy is perplexing. Robert Hahn's article on the Clean Air Act ("The Politics and Religion of Clean Air," *Regulation*, Vol. 13, No. 1, 1990) illustrates this phenomenon. Hahn laments that "one of the more curious notions to emerge from the constant stream of political rhetoric on the environment is that Americans have an *inalienable right* to breathe clean air. If we take this as a religious truth. . . ." In this essay, clearly, religious is not to be taken in a positive sense, but rather to mean something not quite legitimate, certainly something that ignores "science and economics."

This hostility to the demand for clean air and the call for decision making on the basis of "cost-benefit" balances seems inconsistent with basic premises in market theory. The theory of a market economy and its basic concept of equity is that transactions must be freely agreed upon and based upon mutual exchange. I have the right to allow a company to park its trucks on my land; similarly, I have the right to refuse to allow such use. Surely it does not require bizarre religiosity to conclude that by the same standards I must agree before someone else places potentially harmful substances into my lungs. It is not my *right* to clean air that should be doubted, but the emitter's right to destroy a common good, the atmosphere, which he does not own, save by common consent. Cost-benefit analysis provides neither voluntariness nor real transactions. Those put at risk do not freely agree to the risk. Those who pay the costs are typically a different group from those who receive the bulk of the benefits from any particular pollution source.

From an economic efficiency standpoint, clean air is a commodity, like toothpaste or rap music. The public wants this commodity, just as it wants national defense. Like national defense, clean air must be purchased collectively—it is not something that some individuals can enjoy in a neighborhood while others pass it up. We secure the national defense through a combination of regulatory measures and government expenditures; the public pursues its desire to enjoy clean air in the same fashion. Just as one can justifiably question whether we are getting the national defense we want in the most efficient way, the question of whether our current clean air programs get us the commodity efficiently is important and certainly debatable.

Why, then, do Hahn and so many other market advocates turn the question on its head and argue that the public should not want, and has somehow been manipulated into wanting, an inappropriate amount of air quality? They would not devote similar rhetorical energy to the question of whether the public "wants" an inappropriate quantity of toothpaste; people have the right, voluntarily, to consume or not to consume toothpaste. Similarly, they should have the right to consume utterly clean air, if this is what they want and if, collectively, they are willing to pay the price.

There are problems with efficient production of goods that must be consumed collectively. Both defense and clean air programs are vulnerable to common imperfections, and a great deal of analytical work needs to be done to improve both. It is also legitimate to debate whether a given increment of improvement is desirable or not—just as the appropriate level of national defense spending should be the topic for vigorous debate. I might wish that my fellow citizens chose to purchase less rap music than they do; but I do not pretend that their preference is illogically founded in a religious misconception of their rights.

The resistance of market advocates to accepting the validity of the public's demand for environmental goods has an unfortunate consequence. Market solutions to producing environmental goods *efficiently* are not taken so seriously as they de-

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NEWS
21.5 BILLION CLEAN AIR BILL PASSES SENATE

serve because their advocates seem hostile to the very environmental goals their approaches are to yield. Successful automobile salesmen do not begin their approach to a customer by saying, "Look, you don't really need a new car and it's all part of a silly and manipulated concern you have for your status and image, but if you really want to ignore science and economics, have I got a deal for you."

Carl Pope
Conservation Director
Sierra Club
San Francisco, Cal.

HAHN responds:

Mr. Pope notes correctly that there is a difference between the demand for toothpaste and the demand for clean air. The reason we economists do not get exercised about toothpaste purchases is that the marketplace handles such private decisions rather well. Unfortunately, the market does less well on matters involving common property, such as clean air. This is precisely why government has an important role to play in shaping solutions to environmental problems.

There are two questions one might ask about the government's role—one positive and one normative. The positive question is why government behaves the way it does. I tried to address that question in my article. The normative question relates to what government's role should be.

Mr. Pope and I fundamentally disagree on the normative conception of what government should be doing on environmental issues. I would like to see government develop environmental policy with greater reliance on standard economic tools. Unlike many economists, I do not adhere to the religious view that benefit-cost analysis should be the sole determinant in setting goals; nor, however, do I share the religion of many environmentalists, which says that the environment is priceless, and, therefore, the very discussion of costs and benefits is sacrilege. Rather, I would like to see benefit-cost analysis play an important role in major public-sector decisions on environmental issues. Moreover, I would like to see greater attention paid to the *approach* to improving the environment. I think the only way to make sustained environmental progress is to adopt economic approaches that provide industry with a greater incentive to reduce wastes and invent more effective and efficient pollution control methods.

Mr. Pope says that professional economists could win more friends and influence more people if we would only recognize that the public demand for environmental quality is higher than we would like to admit and that we should not question the "facts." He is probably right: We could certainly have more friends—after all, who isn't an environmentalist these days? But, unfortunately, the facts about the public's demand for improvements in environmental quality are subject to dispute. The public is no doubt willing to pay a bundle for improvements in environmental quality so long as it does not see a direct connection between environmental quality and the availability of ice cream cones and VCRs. But if the connection were made more explicit, and the public were asked to pay directly, say through a rigorous inspection and maintenance program for vehicles, the measure of public demand could be very different. Of course, politicians and environmentalists go out of their way to conceal such costs so that the public will be more likely to go along. I do not like that part of the game, but it is unlikely to change.

So where does that leave us? Reasonable people will disagree about the government's role in selecting environmental targets. They will also disagree on the role of economic analysis. I am delighted, however, that a spokesperson for a leading environmental lobbying organization is willing to use economic logic in questioning my arguments. It makes me cautiously optimistic that together we will be able to design more effective and rational environmental policies in the years to come.

Robert W. Hahn

Preaching to the Choir?

TO THE EDITOR:

I am now about three-quarters of the way through the revivified *Regulation*, and I am taking up my pen to congratulate you on having saved it yet again. How nice it is to have *Regulation* back! I am especially enthusiastic about this issue, clean air maven as I am; I hope the same high standards will be applied to the other issues you feature. I am sure they will be.

Permit me one observation. It strikes me that *Regulation* has consistently been guilty of preaching to the choir. This might be avoided if an effort was made to reach out to those thoughtful critics of markets and/or deregulation from time to time. I think back to Steven Kelman's 1981 piece on the vicissitudes of cost-benefit analysis, for example. While many readers disagreed violently with him—myself included—his piece probably educated a lot of them about what the "opposition" was thinking.

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Pieces on the case *for* regulation —whether of greenhouse gases or day care centers—would make *Regulation* a better and perhaps more widely read magazine, in my view. I hope you will make an effort to reach out to proponents and offer them a forum other than *ex post facto* letters of reaction. I am sure this is easier for me to recommend than it is for you to do; such is the nature of arm-chair supervision. But if there is any way I can help you identify such spokesmen, just give me a call.

Once again, congratulations, on having breathed fresh new life into an important journal. I look forward eagerly to future issues.

Paul R. Portney
Vice President
Resources for the Future
Washington, D.C.

Tilting the Marketplace

TO THE EDITOR:

Someone once observed that the world of politics is 30 years behind the world of thought. Your recent series of articles on air pollution control and the pending Clean Air Act legislation (*Regulation*, Vol. 13, No. 1, 1990) suggests how costly that delay may be. For each of the major components of the legislation —acid rain, air toxics, and "smog" control—the articles set out our existing scientific data base and the reasons for doubting that any of the provisions will achieve significant environmental or health benefits.

In many ways, though, the cost ineffectiveness of the legislation may not be its principal flaw. With every major piece of environmental legislation there are complaints that the legislation amounts to overcontrol or is unnecessary. These critiques are legitimate, but they quickly recede from memory. Yesterday's unnecessary overcontrol becomes tomorrow's reasonable provision, as even newer control requirements are pressed. The Clean Air Act debate has followed that pattern over the past two decades, and industry and many academics now wistfully refer to the 1977 Clean Air Act amendments as reasonable legislation. We will be lucky if the world of politics is *only* 30 years behind the world of thought.

The real news in this Clean Air legislation is not that it costs too much but that it is now a dominant vehicle for setting national industrial policy. The combination of a "motherhood and apple pie" issue with a broad statute that affects nearly every industrial activity in the country has proven to be an irresistible invitation to tilt, warp, and bend the marketplace. This is not a new phenomenon in Clean Air legislation. The alliance of the high-sulfur coal industry with environmentalists in 1977 showed the way and demonstrated that Clean Air legislation could be used to lock in markets (the product of that alliance was the so-called percent reduction requirement that was designed to negate the market advantages of low-sulfur coal). But what was begun in 1977 is now being pursued with a vengeance across a broader industrial field.

The pending legislation is nearly 700 pages in length and is as riddled with marketplace manipulations as the Tax Code. For example, our energy policy into the next century is being set by this legislation, whether the issue is the amount of electric power growth allowable, the sources of energy that can be used, or the fuels that will power our cars and trucks. All sides are trying to skew the structure to their advantage. In the acid rain debate, for instance, the administration originally proposed an emissions trading system based on allocating emission "allowances" to individual utilities. These allowances, in effect, will determine the future growth capacity for any utility system. The administration's proposal had two formulas for determining allowances. By the time the bill was through the Senate Environment Committee, there were 8 formulas; there are now 20 and the number is still climbing. These include such classics as special allowances for a "State which has experienced population growth in excess of 25 percent between 1980 and 1988 (according to State Population and Household Estimates, with Age, Sex, and Components of Change . . .)." For the uninitiated, this means Florida.

The same struggle for market share is being played out in the alternative fuels area, as the farm vote has discovered that environmental issues provide an opportunity to specify ever larger percentages of ethanol for automobile use. And similar battles are occurring in nearly all other industrial sectors.

This is, of course, standard fare for the legislative process. What is unique is not the drive for special interest protection, but the breadth and scope of this legislation. Long after the excess costs of this bill are forgotten, we will be living with the industrial policy decisions that were disguised as environmental votes, and in the long run, those decisions may be the most costly.

Francis S. Blake
Partner
Swidler & Berlin
Washington, D.C.

Let NAPAP Reign

TO THE EDITOR:

Implicit from the information in J. Laurence Kulp's article on acid rain ("Acid Rain: Causes, Effects, and Control," *Regulation*, Vol. 13, No. 1, 1990) is the fact that we are not in a crisis situation with regard to acidic deposition; we are not on the brink of an ecosystem disaster as some had once feared. And the research findings from the 10-year National Acid Precipitation Assessment Program also point to such a conclusion—that under present levels of deposition we are not likely to see meaningful changes over the next few decades. Such a situation has important legislative implications.

Reducing emissions of acid rain precursor gases can certainly be beneficial. The question we face is not whether more emissions reductions are wise but at what rate should they be reduced. Emission goals can be achieved by many means: by mandating immediate specific reductions of precursors (as now being considered in Congress) or through more stringent New Source Performance Standards that, through advanced technologies, would achieve the same goal at lower cost and at the gain of the new technologies, but over a longer time period (up to 20 years) but with little difference in acid rain effects.

Inasmuch as we are not facing an imminent crisis, we do have time to examine different approaches and implement that which serves society best in terms of both cost and environmental benefit.

Ralph M. Perhac
Senior Science Advisor
Electric Power Research Institute
Washington, D.C.

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Broadcasting's Future

TO THE EDITOR:

The enlightened assessment of the political economy and the rules of engagement by which the telephone industry seeks entry into the video marketplace provided by Thomas Hazlett ("Should Telephone Companies Provide Cable TV?" *Regulation*, Vol. 13, No. 1, 1990) is most compelling. His generally excellent analysis advanced the terms of this debate by parsing out the essential positions and values advanced by the various industries involved in this debate. However, his characterization of the broadcast industry's position is not entirely on the mark.

I have three points I would like to make in response to Professor Hazlett's analysis of the broadcast industry's position on so-called "telco entry" that will set the record straight.

First, Professor Hazlett posits the inevitable demise of the medium of over-the-air free television, assuming the invincible superiority of broadband distribution technologies such as fiber-optic and coaxial cable. While broadcasters obviously have a self-interest to protect, we do not think it likely from a competitive standpoint, nor desirable from a policy standpoint, that the broadcast medium will disappear anytime soon.

In a study commissioned by NAB and filed with the National Telecommunications and Information Administration in its "U.S. Telecommunications Infrastructure" inquiry, National Economic Research Associates conclude that not only will the distribution role of broadcasting remain vital to the national interest, but that given an equitable policy environment, broadcasting can retain a preeminent competitive position in the marketplace.

While the study goes into greater detail, a number of major competitive and public-interest roles for the broadcast industry are determined to have some longevity. These include localism, universal service, free service, emergency broadcasting authority, mobile service (television consumption is increasingly portable), and socioeconomic contributions (e.g., the importance of advertising and programming to domestic and international trade and the socialization and transmission of culture functions).

The broadcast industry requires policy relief so that the value it creates in the marketplace flows proportionately back to the broadcasters. The "if carry/must pay" proposal advanced by the industry is a step in this direction. Under this proposal, broadcasters would be able to tap into the excess profits stream generated by cable operators. Since about two-thirds of the viewing in cable households is of broadcast services, something more than the minuscule payments for distant and no payments for local broadcast services would put the marketplace in better order.

The second point I would like to make deals with Professor Hazlett's misunderstanding of NAB's position on telco cross subsidization, i.e., the ability to use the rate-regulated revenue base to subsidize the competitive operations so as to disadvantage competitors. Simply put, NAB is on record as opposing cross subsidization. We do not believe that it is practical for regulators to adequately enforce any stringent cross subsidization safeguards, however wisely and imaginatively drawn.

The only way to effectively prevent cross subsidization by telephone companies is to restrict their status in the video marketplace to that of common carriers.

Therefore, rather than not being concerned with the cross subsidy issues as Professor Hazlett suggests, this concern is the exact focal point of our position statement. It is curious that Professor Hazlett does not see this. It is my impression that all good scholars check the facts on which they base their analysis, and if Professor Hazlett had bothered to ask me, I would have explained the position in these terms.

The third and final point I want to make is that broadcasters are not Luddites. We not only accept, we welcome the inevitability and even desirability of fiber-to-the-home services. The promise of fiber for adding to the richness and diversity of telecommunications services to the U.S. consumer cannot be overstated. It will take hard work to realize these promises, and certainly existing industries will be affected. Broadcasters will be at the forefront in capitalizing on new opportunities created by having a competitive broadband distribution system available to American homes. Our major concern is that rather than detract from the kind of broadcast and video services consumers now enjoy and that are the envy of the world in building up our new telecommunications infrastructure, let us take a good thing and make it better, not worse.

John D. Abel
Executive Vice President
National Association of Broadcasters
Washington, D.C.

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Currents

Straws in the Wind

Regulation appears to have been relaunched into a headwind. A *single* issue of the *Washington Post* (3/3/90), for example, included articles on the following regulation, antitrust, and trade topics.

- A bipartisan congressional commission endorsed a proposal to provide comprehensive medical insurance and nursing home care. As in the current Massachusetts plan, all employers would be required to provide medical insurance for employees and dependants or to pay into a public plan to provide this insurance; this is estimated to cost employers about $20 billion a year. The only major disagreement in this commission concerned the failure to propose a plan to finance the additional federal cost, estimated at about $66 billion a year, of the other parts of this proposal.

- Securities and Exchange Commission Chairman Richard C. Breeden endorsed a bill broadening SEC regulation of brokerage firms to other financial activities within the same holding company, citing the bankruptcy of the Drexel Burnham Lambert Group as a case study in support of this bill. Breeden did not mention that no one other than the owners and creditors of Drexel appears to have been harmed by Drexel's failure.

- A California Superior Court judged ruled that the state's antitoxics law be extended to food, drugs, and cosmetics, which will roughly double the number of products covered by this voter-approved initiative. Under this law, manufacturers and retailers must either eliminate all ingredients that may cause birth defects or cancer or label such products as hazardous, even if these products cause no discernible health risks to humans.

- The Department of Transportation ordered airlines to provide a range of special equipment and services to disabled passengers, including wheelchair access to lavatories and free travel for any required attendant.

- A federal court in North Carolina ordered the Brown and Williamson Tobacco Corporation to pay $148.8 million in damages to the Liggett Group, based on a finding that Brown and Williamson sold cigarettes at a lower price than that of Liggett's own discount brands.

- And President Bush, playing the good cop to Congress' bad cop routine on trade policy, leaned on Japanese Prime Minister Toshihi Kaifu to change a number of Japanese domestic government and business practices, even though these practices are consistent with international trade rules and similar to practices in the corresponding industries in the United States. Meanwhile, Congress, in a renewed outburst of mercantilist machoism, threatened to make U.S. sanctions mandatory if the Japanese and other nations do not acquiesce to such U.S. pressure.

All in all, this was a pretty good day for those who believe that the government knows best how to run our economy and even that of other nations.

A more disturbing signal of the outlook for regulation during the Bush administration has been the emasculation of the Office of Information and Regulatory Affairs in the Office of Management and Budget. This office had been the primary check on regulatory excesses during the Reagan administration and was strongly supported by then Vice President Bush. The administrator of this office resigned last summer, and no political official has yet to be appointed to head this office. The reduced status of this office was reinforced by a number of subsequent events.

- On December 20, 1989, the Environmental Protection Agency issued a ruling that all municipal waste combusters must recycle at least 25 percent of all waste, over the objection of both OIRA and a White House Counsel. This rule will increase both the use of replacement fuels and the amount of waste deposited in landfills, thereby substantially increasing municipal expenditures without any net beneficial environmental effect—all of which was identified by the OIRA review last fall.

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• On February 21, 1990, the Supreme Court ruled that the Paperwork Reduction Act of 1980 did not permit OIRA to overrule agency requirements to disclose information on food ingredients and hazardous chemicals.

• And the paperwork continues to accumulate. One example that will go from the Government Printing Office to landfills in record time is the recent report by the Department of Energy on the environmental impact of alternative siting of the new superconducting supercollider. This report, all 23 volumes and 8,000 pages, was mailed to 17,000 recipients, including those who had merely signed letters endorsing the siting of the supercollider in their district.

The White House regulatory review process, initiated in the Ford administration and strengthened in both the Carter and Reagan administrations, has been seriously weakened. This process was designed to serve a parallel role to the presidential budget process—to identify and discipline federal measures that impose significant costs on the economy. One might hope that President Bush would recognize and support a process that was one of his major contributions as Vice President.

According to Greek legend, Cassandra, a daughter of the King of Troy, was given the gift of prophecy by Apollo, who later, however, decreed that no one believe her. The editors of *Regulation* have no wish to be contemporary Cassandras. We dearly hope that our pessimistic outlook on the prospect for U.S. regulation in an increasingly competitive world will prove to be mistaken. But that will only happen if others recognize both the benefits and costs of these measures and act to discipline the political process that generates these measures.

W.N.

Europeanizing the American Economy

Most European workers enjoy benefits not broadly available to their American counterparts. Though specific labor market regulations vary across countries, a list of common European benefits might include a higher minimum wage than in the United States, mandatory employer-paid medical insurance, plant-closing notice and severance pay requirements, paid parental leave, more generous paid holidays and vacations, and requirements that private employers hire a specific proportion of disabled workers. The differences in the regulation of U.S. and European labor market conditions have not escaped notice in this country. Advocates of additional mandated employment benefits in the United States—medical insurance, pension rules, plant closing laws, and accommodations for the disabled, which this issue of *Regulation* examines—often point to the "more civilized" approach taken in Europe. Before we rush to embrace the European model of labor contract regulation, however, it is important that we take stock of all the differences that exist between the American and European labor markets.

Of particular note over the past decade has been the dramatic divergence between the United States and Western Europe in unemployment and job creation. While the American market has flourished since the mid-1980s, many European economies have stagnated. In 1989 the unemployment rate in the United States was 5.2 percent. For the European Community as a whole, the unemployment rate was 9.5 percent. Specifically, in West Germany the unemployment rate was 7.3 percent, in Italy it was 12.0 percent, in France 9.5 percent, in the Netherlands 7.6 percent, and in the United Kingdom 6.5 percent.

Even more startling is a comparison of the number of new jobs created in the United States and Western Europe. From 1980 to 1988 the U.S. economy created 15.7 million net new civilian jobs. Despite their larger population, the economies of the European Community created just under 4 million net new civilian jobs during the same period. In the United States civilian employment increased by 15.8 percent. Our closest competitor among the six major European countries was the Netherlands, where civilian employment increased by 7.4 percent over the same period. In France civilian employment declined slightly, and in the European Community as a whole, the

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number of individuals employed in nongovernment positions increased by only 3.2 percent.

Nor is this job growth in the United States only a phenomenon of the Reagan years. From 1973 to 1988 the U.S. economy added 29.9 million new civilian jobs to increase the number of individuals employed in the private sector by 35.2 percent. Over this same period the European Community added 5.6 million net new civilian jobs for a 4.6 percent increase in total private-sector employment. This period is particularly important, of course, because it marked an era during which the postwar baby boom was being absorbed into the work force with women entering the job market in record numbers. Thus, it is also useful to compare how women have fared in the United States relative to the European countries.

In the Winter 1989 *Journal of Labor Research*, Department of Labor analysts Ronald E. Kutscher and Constance E. Sorrentino reported that the employment of American women rose by 50 percent from 1973 to 1986. During the same period, the employment of women in the six major European countries rose by just 13 percent. Kutscher and Sorrentino went on to note that over half of working-age women are now employed in the United States. Only Scandinavian women have higher work-force participation rates. The economic activity of women in Europe is rising but at a much slower rate than the increase in activity among American women. Only 30 percent of Italian and Dutch women work outside the home, while only 40 percent of French and German women hold jobs.

Why is it that the Europeans have failed to match the labor market performance of the United States? According to Gottfried Haberler of the American Enterprise Institute, "The microeconomic classical interpretation regards the high European unemployment as structural and spotty due to inflexibilities, rigidities, and immobilities, especially in the labor market."

In other words, the extent to which European countries have specified the benefits that must be provided by employers has increased the cost of hiring—and of firing or laying off—European workers. The minimum wage plus the cost of providing the required benefit package establishes a floor under effective wage rates. If that floor is above the market-clearing wage rate, some would-be workers will be involuntarily unemployed. Looked at another way, as the cost of the total required compensation package has become increasingly large relative to the portion of the money wages over which employers and employees have control, both employers and workers have found themselves locked into an ever-more rigid system. Neither side can offer to make adjustments that might mitigate the impact on employment of an economic downturn. Nor will employers rush to rehire laid-off workers when conditions seem to improve; the costs of a mistake are just too high. As a result, there is a lower level of total private employment in Europe than in the United States, and Europeans who are laid off tend to stay unemployed longer than Americans who lose their jobs.

Nor does the cost of a relatively high total compensation floor fall equally on all sectors of the economy. There are a multitude of labor markets within any one economy, even within a single firm. Each "market" has a different equilibrium wage depending on the skills or requirements of potential employees and the specific needs of each employer.

The larger the percentage of an individual employee's total compensation package that is accounted for by required compensation, the more likely it is that he will pay for benefits with unemployment—particularly during recessions. In a regime with extensive mandated benefits, high school dropouts are more likely to find themselves unemployed than are college graduates. Similarly women, especially less-skilled women, will more often find themselves out of work in the presence of government-mandated parental leave (even unpaid leave) than in its absence.

In their article Kutscher and Sorrentino also observed: "Employers with fewer restrictions are more willing to hire workers and are particularly less concerned with the specific education, training, or other credentials needed for a given job." This not only leads to greater upward mobility in a labor market marked by greater flexibility, but also opens more ground-level doors for the unskilled. Employers who are not burdened by a host of mandated labor costs will be more willing to provide on-the-job training and take a chance on untried employees. Increasing the costs of employment would concomitantly reduce the opportunities available to those who have not proved themselves with adequate schooling or past employment experience.

Finally, with respect to the costs of mandated benefits faced by individual workers, advocates of change should remember that the increased unemployment rates caused by enacting a host of mandated benefits will also make it easier for em-

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ployers who are so inclined to discriminate against women or minorities. The greater the number of people applying for a job opening, the easier it is to hire a qualified employee with characteristics consistent with the employer's prejudices. And as Richard Burkhauser notes in his article on benefits for the disabled, even government requirements that employers hire members of disadvantaged groups are not always adequate protection.

But more strictly regulating employment contracts would not only affect employment prospects for individuals, it would also change the structure of the U.S. economy by influencing the mix of firms that survive. The costs of labor contract regulations fall disproportionately on small businesses, a fact that is not lost on larger U.S. firms that already provide their workers with many of these benefits. It is not surprising, then, as Simon Rottenburg points out in his article on mandated medical insurance, that some large U.S. firms are acquiescing to, if not encouraging, strictly legislated standards in this area. After all, making life more difficult for entrepreneurial companies would relieve large corporations of the need to remain innovative and cost-efficient. Life would no doubt have been more serene for IBM executives if Apple had been unable to get off the ground because of expensive, inflexible labor compensation rules. This in itself should give pause to individuals concerned about the overall welfare of consumers and workers.

Upstart companies not only add to the quality of life in the United States through the products and services they provide. They also contribute the lion's share of the new jobs created each year. From 1980 to 1987, for example, the number of individuals employed by the Fortune 500 declined by 3.1 million, but the rest of the private sector added 16 million jobs, and the vast majority of these were in firms with fewer than 100 employees. During the late 1980s, approximately 1.3 million new enterprises were started each year. And though 8 to 10 percent of U.S. corporations are closed or absorbed each year, David L. Birch from the Massachusetts Institute of Technology reported in the Winter 1989 *Journal of Labor Research* that recent data show that the odds of holding the same job from one year to the next are actually higher with smaller companies than with the corporate giants.

Increasing the costs and reducing the flexibility of the most dynamic of our firms cannot help but reduce the rate of job creation in the United States. This will lead to a larger portion of the workforce without any benefits, not even the benefit of a job and a paycheck.

If our goal is to provide all segments of the U.S. labor force with opportunities to work and advance, then there is no doubt that increasing rather than reducing the flexibility of employers and employees in the labor market is the right course. Only a select group of U.S. citizens will gain from any attempt to emulate the Europeans, and those who gain will come disproportionately from already advantaged groups.

But before leaving this subject, it is worthwhile to note that tremendous changes are afoot in the United States and throughout the world. The baby boom generation is now at work, and employers everywhere are beginning to look for new employees among the "birth dearth" generation. As *The Economist* noted in its January 6, 1990, issue, during the 1990s and into the early 21st century, the pressure will shift increasingly to employers to find ways to attract and retain qualified staff. Rather than having several qualified applicants line up for each job, several firms are likely to line up for each applicant.

As a result, many of the changes that advocates of mandated benefits seek will begin to appear voluntarily as "the shortage of younger workers will mean that companies in America, Japan, and Europe will have to find new ways to attract, develop, motivate, reward, and retain employees." Companies are expected to reach out increasingly to nonworking mothers and the elderly. It is expected there will be more attention to on-the-job training and subsidized schooling as well as benefits that enhance the quality of life for employees. Not everyone will benefit to the same degree from these changes, but to ensure that such benefits are as widespread as possible, we should oil, not hobble, the American job machine. We should think twice before Europeanizing the American economy.

C.E.

An Elegy to the Barbarians

A short history of the 1980s according to lots of people: greedy yuppies ravaged fine old companies and finally got their come-uppance with the collapse of Drexel Burnham Lambert, the junk

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bond specialists that fueled the takeover boom. Phil Donahue captured the feelings of many when he told a group of former Drexel employees: "You not only were arrogant, you were snobbish, and in lots of ways, very impolite and mean. . . . Nobody likes you. You're Wall Street yuppies and you've got a bad image. . . . I mean you are mostly white, mostly Northeastern, Yale, Harvard types. You are mostly Republican. You were raised in Connecticut. You never ride the subway. So who gives a damn about you guys?"

The same accepted wisdom views the RJR-Nabisco takeover by the leveraged buyout specialists Kohlberg Kravis Roberts & Co. as the low point in the takeover wars. A best-seller about this transaction, Bryan Burrough and John Helyar's *Barbarians at the Gate*, gives us a chance to evaluate this wisdom.

As they indicate in the title, Burrough and Helyar emphasize the unsavory aspects of the characters who battled for control of RJR. They are all guilty of some combination of unbridled egomania, greed, mendacity, and even bad manners. Many who read this book will undoubtedly come away with the feeling that it is about time the takeover game ended, just to get bums like this out of the way. It is time to get back to doing business the old-fashioned, genteel way.

As it turns out, you really cannot tell the bad guys by who rides the subway. In fact, we may someday see RJR-Nabisco as the takeover game's finest hour. Now that takeovers are being regulated out of existence, this transaction provides an opportunity to look wistfully at what we shall be missing.

The RJR-Nabisco takeover, as told by Burrough and Helyar, begins with Ross Johnson, RJR-Nabisco's CEO. Johnson had the good life as the chief executive of a publicly traded company with plenty of cash and not much debt. Think of the things he could do with the cash. He could have flashy golf tournaments and keep a bevy of glamorous athletes on the payroll at up to a quarter million dollars each. He could keep a fleet of corporate jets dubbed the "RJR Air Force" with a glitzy $12 million private hangar in Atlanta. (Once one of these jets was enlisted to fly a passenger listed on the manifold as "G. Shepherd," a.k.a. Johnson's dog Rocco, safely out of Palm Springs after he bit a security guard.) He could have lavishly decorated headquarters. After all, cigarettes and brand names generate so much cash that, as Johnson reportedly said, "A few million dollars are lost in the sands of time."

One might wonder how Johnson got away with all this. Part of it was that he was not a bad manager. He also knew how to use his control over corporate cash to take care of board members. Some got rich consulting contracts. One got his bank a contract for servicing RJR-Nabisco shareholders. Another got a chair at Duke endowed in her name.

Not surprisingly, Johnson did not leap at early suggestions that the company do a leveraged buyout. "For all his free-spending ways," note Burrough and Helyar, "the fact was Johnson remained a prude about corporate debt, the core of any LBO. . . . Banks didn't understand the need for golf tournaments and corporate jets. They cramped his style." More to the point, Johnson would not have so much cash around after an LBO because he would have to make regular principal and interest payments, and the banks might demand covenants specifying what the company was supposed to do with whatever cash it had. And any substantial investor in an LBO would certainly want some say in management. As Burrough and Helyar observe, "Johnson wasn't interested in working for anyone other than himself." Most of us would sympathize with that sentiment.

Johnson ultimately went along with the idea of an LBO because he believed that RJR-Nabisco stock was "underpriced" compared with companies such as Philip Morris. Maybe Johnson was genuinely interested in shareholder value. Or maybe the stock price made him nervous because he saw the writing on the wall. The takeover market would not ignore forever the opportunity for a profit in RJR. Best if Johnson got the idea first.

The original buyout bid was $75 per share, for a total of $17 billion. Johnson initially objected to a higher price because that would require more debt, less free cash, and more belt-tightening. Burrough and Helyar describe Johnson as "a man with absolutely no stomach for cost cutting, certainly not if it meant cutting back the RJR Air Force or other perks." They quote him as saying "I don't want my life-style to change. I've got a great company, a nice life, I don't want to change the way I live."

Under the management agreement advanced in connection with Johnson's original LBO proposal, he got the buyout manager to cede to Johnson a veto power over major strategic decisions. He said, "For Christ's sake, I'm not going to have a bunch of bloody investment bankers on my board telling me what I can do and what I can't do."

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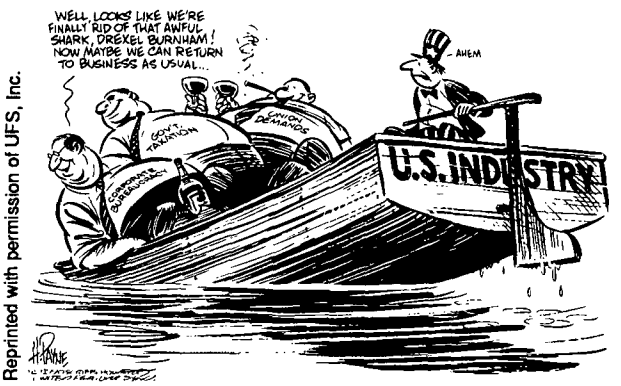
WELL, LOOKS LIKE WE'RE FINALLY RID OF THAT AWFUL SHARK, DREXEL BURNHAM! NOW MAYBE WE CAN RETURN TO BUSINESS AS USUAL...
AHEM
U.S. INDUSTRY

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Johnson and six other managers would also get up to 18.5 percent of the equity at no cost if the postbuyout company met incentive objectives.

Then began the auction for RJR-Nabisco. It was an auction Johnson's group seemed sure to win. To fund a deal of this size, Shearson Lehman lined up what it thought was all of the bank financing in the world available for a single deal. The negotiating committee of the board was hand-picked by Johnson. And any competing bidder would start out well behind the eight ball in trying to get information from insiders (who suffered from "collective memory loss" when talking to KKR people) and securing their agreement to cooperate with the takeover.

Nevertheless, Kohlberg Kravis won the auction with a bid of $109, almost 50 percent more than Johnson's original bid. This enormous increase in price suggests that Johnson had tried to steal the company. KKR prevented the theft for one simple reason: they got junk bond financing arranged by Drexel. This much debt could be serviced only by taking tight control of the company. There would be no veto power for incumbent management. Most of the jets were sold, the expensive athletes were released, and corporate apartments were sold. (The airplane hangar proved to be unsaleable.) Premier, a $300 million smokeless cigarette that could not be lit with a match, was buried.

What is the moral of this story? One possible view, seemingly the popular one right now, is that takeovers are bad. This takeover unsettled thousands of employees and creditors and left Winston-Salem bereft of a major corporate benefactor. Driven by Henry Kravis' tremendous ego, KKR ran up the bidding to the point that RJR-Nabisco has become dangerously leveraged. So the law should step in and make takeovers more difficult.

Indeed, the law has done just that. Drexel, the major market-maker for junk bonds, is now gone. The ultimate cause of its demise is still in doubt, but the firm was not helped when it was forced to either pay a $650 million fine or face virtually certain shutdown under RICO. In addition, it is not likely in the current regulatory environment that any firm will commit the resources necessary to build a junk bond juggernaut comparable to Drexel's. Banking regulators have reduced banks' abilities to finance takeovers with loans, and the savings and loan bailout has forced thrifts out of the junk bond market. (Deposit insurance and other misguided regulation may have caused these problems, but junk bonds are what regulators chose to fix.) Finally, state antitakeover statutes have proliferated and become stronger.

Even more antitakeover regulation looms. A statute passed in Pennsylvania virtually bans hostile tender offers. U.S. Sen. Terry Sanford, in cosponsoring a bill that would limit the ability of banks and pension funds to invest in LBOs, vowed to "keep other communities from suffering from the 'Barbarians at the Gate.' "

The recent Time-Warner combination provides a good example of the effects of the new takeover landscape. Here the takeover battle was begun when the Time board resolved to merge Time and Warner. The exchange ratio of Time stock for Warner stock included a hefty premium for Warner. Just as the shareholders were asked to vote on the transaction, Paramount made a takeover bid for Time at a price significantly above both the current trading price of Time and the likely per-share price of Time-Warner.

The Paramount bid understandably made Time's directors nervous. So the Time board simply restructured the Warner transaction into a two-step tender offer by Time for Warner that did not require a vote by Time's shareholders. This transaction was designed to be completed before Paramount would have a chance to acquire Time. In other words, the Time board made sure that Time's shareholders would not have the opportunity to choose between the Warner merger and Paramount's cash bid.

It is at this point that we see the effect of the new takeover landscape. If Time was better off without the combination, or better off combined with somebody else like Paramount (as indicated by the price of Paramount's bid), it was technically not too late for Paramount or somebody else to make a bid for the combined company (which had about the same value as RJR-Nabisco), sell off

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one of the pieces, and maybe toss out the executives who thought up this transaction. True, it would have been too late for the Time shareholders whose money was already in the Warner shareholders' pockets. But at least the final result would have been a stronger company. And the simple fear of this potential market discipline might have prevented the Time-Warner transaction in the first place.

But the regulators had seen to it that potential sources of financing for takeovers were in sufficient disarray that financing could not be found for another transaction the size of RJR-Nabisco. In short, the Time board had nothing to fear. Nobody could make a bid for the combined company.

And now the Time-Warner transaction itself has spawned a new threat to the viability of takeovers. Paramount sued to block Time's restructuring of the Warner transaction from a merger to a tender offer. The Delaware Supreme Court could have upheld the transaction on the narrow ground that the Time board was technically within its rights to continue with a corporate acquisition. Instead, the Court left the distinct impression that it would allow boards of directors of target companies to take even stronger actions to preclude the shareholders from having the last word. For example, a board may now be able to leave a strong "poison pill" in place, precluding any bid for the company.

This means a bleak future for takeovers. True, something of the board's fiduciary duties to shareholders survives in the new takeover landscape. If management proposes a buyout, it still must open the bidding. But who can now get into a highly risky bidding war with incumbent management? And more important, management does not have any pressing need to start any auctions for the company. Why should a low stock price make managers nervous? Even if a hostile bidder does try to start something, and even if the bidder is able, despite everything, to obtain financing, managers may be able to crouch behind an impregnable legal fortress.

So gentility has returned, for now, to the corporate world. The greedy egomaniacs are in retreat. We are left with selfless managers who think only of their shareholders and the good of society. Or so many people seem to believe.

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Good Enough for Government Work: Why *Moving America* Is Unsatisfactory

Moving America: New Directions, New Opportunities, Secretary Samuel K. Skinner's Statement of National Transportation Policy, is a typical government document. Prepared by a committee, vetted through an interagency process designed to remove anything controversial, it is replete with such *bold* statements as: "Nothing is more important to the American people than their safety and security, and the security of the Nation." "The environment and the quality of life are important to Americans." "The Federal Government sets a standard for fiscal responsibility [sic]." "It is Federal transportation policy to spend transportation trust fund balances over time in a fiscally responsible way."

Bromides such as these would have their place if they had content, were believable, or led to important policy proposals, but the policies actually proposed are half-hearted. The recommendations are tame and consistent with the conventional Washington policy mind set. What is finally most disappointing about this tract is not what it says but what it leaves out.

According to Secretary Skinner, this document was needed because "it is time to take a new look at our transportation policies, to take stock of what those policies are doing well and poorly, and to set a course that will ensure we have a transportation system that supports our national goals for the future."

Notwithstanding those sentiments, the policy statement pays little attention to those policies that have worked well, such as airline deregulation, nor does it devote much space to those policies that are doing poorly. For example, if the department were to be honest about policies that were functioning poorly, *Moving America* would have analyzed FAA operations and made recommendations.

Policy Proposals

Moving America contains a number of worthwhile proposals, but they will take political pressure to implement. In particular, the report emphasizes peak-load pricing, user charges, reduced spending on mass transit, airport passenger charges, reforming railroad labor legislation, eliminating subsidies for Amtrak, limited reform of merchant

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marine subsidies, and abolishing the remaining regulations on trucking.

Peak Pricing. The policy paper does recommend that prices be used to reduce congestion. Peak-load pricing would help alleviate traffic jams by inducing the public to travel at less busy periods. The proposal is vague, however, and appears to refer to auto traffic, although peak load pricing could also have a major role to play in rationing scarce landing and takeoff rights at crowded airports. Except for three brief references to using the pricing mechanism to control congestion, the report provides no specifics or examples.

Peak pricing of landing charges would help alleviate congestion at many busy airports. At the end of the Reagan administration, the Department of Transportation charged that levying higher rates during congested periods at Logan Airport was discriminatory and was prohibited. If the report had repudiated that position or, at a minimum, had specified that peak charging for landing fees was appropriate, the issue would have been clarified. Instead, a useful opportunity was wasted.

In fact, *Moving America* includes a puzzling ambiguity about peak pricing. One section calls for "greater attention to . . . peak period or congestion pricing;" another part simply suggests that "research is . . . needed on . . . the effective use of pricing mechanisms to manage demand;" a third section asserts that "the Department will encourage pricing . . . for all modes where there is system congestion."

User Fees. In two other useful but brief sections, the Department of Transportation vows that the government will rely more heavily on user charges. The emphasis in these few sentences is primarily on the revenue aspects of user fees, probably reflecting the insistence of the Office of Management and Budget on including such revenue devices in the report. In addition to raising revenues, user fees have other benefits. Charging for a service, such as using air traffic controllers, rations the demand for the service to those who find that its value exceeds the cost. When a service is provided without charge, consumers will use the service excessively.

In a section dealing with aviation legislation, the department claims that it "will recover a higher portion of program costs from user fees and increase the size of Federal aviation programs." That sentence comes as close as the report gets to discussing the issue of proper payments by general aviation. General aviation receives significant benefits from the air traffic control system and from federal aviation expenditures without paying anything close to the costs it imposes on the system. But general aviation has had strong political support on Capitol Hill and has managed to fend off attempts to impose user charges. By neglecting to mention the subject, this report contributes to the impression that general aviation will continue to benefit from the system without having to pay adequately for it. Not only does the present system impose a cost on taxpayers and other users, but it results in private pilots' overutilizing the system since they do not have to pay the full cost.

An important innovation, although it has received only poorly thought-out criticism, is the proposal to allow greater use of toll financing on federal-aid highways. Again charging for the use of highways not only makes budgetary sense but also rations the use to those who value driving the highway more than the cost of the toll. If imposed, tolls would reduce congestion and provide funds for maintenance and construction.

Reduced Federal Subsidies. The report recommends reduced federal subsidies for mass transit, Amtrak, and the merchant marine. Urban mass transit systems are inherently a local issue. There never has been an adequate justification for federal aid to mass transit. Any benefits from a mass transit system go to the residents of the community.

Moreover, federal aid has tended to foster the construction of inefficient, wasteful projects. *Moving America* recognizes this failing when it claims that federal aid "has encouraged the construction of new rapid rail systems and discouraged investment in more cost-effective alternatives." Moreover, the report admits that "the results of [investment in new rapid rail systems] were often disappointing." This is undoubtedly an understatement. Ridership has been almost universally less than forecast and has been inadequate to pay the capital costs or even cover the operating expenses in most cases. Taxpayers, either federal or local, have normally been forced to pay for these systems.

While *Moving America* stresses the need to save energy and implies that mass transit would be useful in that regard, it fails to take into account the energy cost of constructing fixed rail systems.

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It often takes more energy to build the system than will ever be saved by riders' shifting to mass transit from cars or other modes of public transportation.

The Department of Transportation's policy document has wisely called for reducing operating assistance for mass transit. A more forthright approach would be to abolish such assistance entirely; but, as is typical in this report, a timid proposal is put forward rather than the bold and more appropriate recommendation.

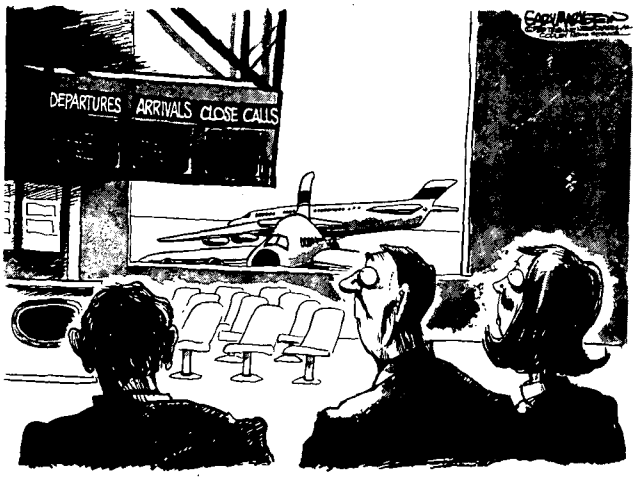
The Department of Transportation also urges that Amtrak's subsidy be eliminated. Virtually all of the Reagan administration's budgets also recommended zero funding for Amtrak but without success. Amtrak has, however, made progress in reducing its need for a subsidy and is close to being able to operate without any federal taxpayer aid. In the Northeast corridor it is likely that Amtrak could cover its costs if it were freed from railroad labor legislation that restricts its ability to keep expenses under control.

While Secretary Skinner has the political courage to call for the abolition of Amtrak subsidies, he is less courageous in dealing with water-borne commerce. This policy document simply asserts that "subsidy programs for the U.S. merchant marine must be re-examined" and that the operating differential subsidy should be reviewed and restructured. Given the timid nature of the DOT document, it is scarcely surprising that it should take such a weak position.

Since there is no economic justification for this subsidy, these programs are normally rationalized on the basis of national security. In reality, however, any national security rationale is specious. Should a national emergency arise, merchant shipping could be expanded rapidly. For example, in the first three years of World War II, the U.S. multiplied over thirty-one times the output of U.S. shipyards, from 53 new merchant ships in 1940 to 1,661 in 1943.

The Department was somewhat more forthright in recommending that U.S. operators in foreign trade be permitted to acquire vessels from foreign shipyards. The requirement that U.S. flag vessels be built in U.S. yards is simply protectionist and imposes serious competitive disadvantages on our merchant marine.

While most of the recommendations in *Moving America* are helpful as far as they go, an endorsement of the Jones Act is harmful. This act restricts all water transport between U.S. ports to U.S. flagships. Not only must such vessels be built in U.S. yards, but they must be manned by Americans. Since U.S. shipyards are two to three times more expensive than foreign construction and since U.S. merchant marine employees cost roughly double those abroad, domestic water transport outlays are significantly higher than those in much of the rest of the world. The costs of these policies are endured mainly by consumers in Hawaii, Alaska, and Puerto Rico.



As a result of this form of protectionism, domestic coastal shipping is virtually dead. In addition, Congress has prohibited the export of Alaskan oil to force the use of U.S. tankers manned with American seamen. Alaskan oil could more profitably be exported to Japan than dumped on the West Coast or taken expensively through Panama.

Airport Fees. To increase revenue for airports, *Moving America* proposes legalizing the right for airports to collect passenger facility charges. Under this recommendation airports could charge a head tax for passengers who either depart from or arrive at an airport. The funds generated would then be used to expand the airport, increase landing capacity, or improve the airport's amenities. This revenue would also make airports less financially dependent on their tenant carriers and would encourage them to provide more facilities for new carriers, a significant benefit that the document ignored. Competition at airports that are dominated by one or two carriers could thus be enhanced.

The Airport and Airway Trust Fund currently collects revenue from a tax on airline tickets, an international departure tax, a way bill tax, and a

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fuel tax. The Department of Transportation allocates grants to airports for constructing and maintaining landing facilities and certain other activities. Airports often have to defer expansion plans until they win funding from Washington. If the transportation plan had also proposed authorizing airports to opt out of the airport/airways trust fund financing and, in return, receive a portion of the ticket tax directly, airport authorities would have had much more flexibility in developing their facilities.

Air Traffic Control. The cautious nature of the report is reflected in its failure to consider further privatization of air traffic control. The document does maintain that "private sector participation . . . offers significant benefits [at] air traffic control towers at *low*-activity airports" (emphasis added). If privatization works for low-activity airports, why not for other airports? In fact, Britain has successfully privatized air traffic control with lower costs and greater flexibility. Moreover, the training of air traffic controllers could also be privatized, with the likely benefit being lower training outlays.

Airports allowed to hire their own controllers would have greater flexibility to expand their facilities without having to ask Washington for grants and more controllers. As other DOT documents have pointed out, a number of airports are operating at close to capacity and cannot offer additional gates or landing rights to carriers that are not already tenants. As a result, competition is being stifled.

Airline Competition. Secretary Skinner's report does propose "new approaches to allowing additional [foreign] air service to U.S. communities." He adds, however, the caveat that the interests of U.S. carriers will be properly taken into account. How about the interests of the flying public? Protectionism is alive and well in the Department of Transportation.

There is no consideration at all of weakening or eliminating the cabotage laws. Allowing foreign carriers to transport passengers between points solely within the United States would increase competition on domestic routes. In addition, to the extent that consolidations in the domestic industry have reduced competition, removing cabotage restrictions would reinvigorate it. Certainly it is hard to see how a foreign-owned airline would harm the national interest. Such an airline would undoubtedly have to employ American pilots, mechanics, flight attendants, and baggage handlers. Only the stockholders and perhaps top management would be foreign. Currently, any American who is qualified can start an airline. Why not foreigners? This issue was not even hinted at in Skinner's document.

Railroad Labor Legislation. The sections the national transportation policy statement devotes to railroads are commendable. The Secretary's document calls for reform of work rules, pension requirements, and labor legislation that apply only to railroads and impose significant costs on the industry. Such rules were introduced when rail transportation was the principal method of moving goods and people. These laws not only are unnecessary today but retard the ability of railroads to compete with other modes of transportation. Although organized labor will fight any reform efforts, the Department of Transportation is right on target in recommending the repeal of these laws.

Surface Transportation Regulation. The Department of Transportation has followed the Reagan administration in recommending that *all* remaining regulation of trucking, intercity bus, interstate rail passenger, interstate barge, ferry, pipeline (other than water, oil, or gas), household goods freight forwarder, and freight broker services be repealed. Such a move is long overdue. The Reagan administration, which did recommend abolishing the remaining controls in its last term, passed up the opportunity to advocate deregulation during much of its time in office. The Bush administration has moved more expeditiously.

The remaining controls on trucking are adding to paper work, limiting price competition, and leading potentially to higher rates and monopoly profits. Firms attempting to enter the motor carrier industry, for example, must still apply for certificates of public convenience and necessity. These operating permits specify the products that can be carried and the territory in which the firm may offer its services. After the motor carrier receives its certificate, it must file its tariffs with the Interstate Commerce Commission. Whenever it wishes to change its rates, new tariffs, subject to challenge by competitors, must be filed. In recent years the Interstate Commerce Commission has been reasonably permissive about granting new certificates and allowing firms relative freedom

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in rates, but a less competitively minded commission could become much more restrictive.

Secretary Skinner has actually taken one major step beyond the Reagan administration. Because of its dedication to states rights, the Reagan administration was reluctant to preempt state regulation of trucking. The new policy document recommends that the government "ensure that State economic regulation of motor carriers, including intrastate operations of Interstate motor carriers, does not conflict with Federal economic regulatory standards for interstate commerce."

In fact, the most onerous regulation of trucking in the United States today is practiced at the state level. Texas, for example, is notorious for its limitations on entry and consequent high freight rates. The movement toward state deregulation, which was strong in the early 1980s, has apparently stalled. Since state regulation is a form of protectionism for certain vested interests, forcing states to abolish their controls over intrastate trucking is warranted.

The department also pledges that the federal government will "vigorously oppose efforts to reregulate railroads and airlines." For both modes, attempts to reimpose regulation continue. Coal shippers, power companies, and some grain interests want to increase price controls over railroads. In fact, the partial deregulation of railroads has resulted in lower rates overall for rail transportation, but these shippers believe that they can force even lower rates with regulation.

Airline deregulation has been opposed from the start by pilots, mechanics, and flight attendants. Indeed, organized labor lost bargaining strength with deregulation, and wage rates and working conditions have become more like those throughout the rest of the economy. In fact, the only significant losers from airline deregulation have been the unionized employees and their unions.

For some communities, mainly small cities, air fares for short trips to nearby hubs have increased. Where airlines have achieved dominant positions at certain airports in the process of establishing hub and spoke systems, rates between those hubs and small cities without much competition have become higher than those for long-haul routes through the same points. But even travelers from these communities have benefitted from the lower fares on the long-haul routes. Despite these gains, a recent up-tick in air fares, which was perfectly understandable under recent market conditions, has contributed to a disenchantment with air service. As airlines have achieved the potential economies of deregulation, rates have, of course, stabilized and with higher fuel prices and increased demand have even increased in the past year.

These conditions have led some who have failed to study the matter to conclude that reregulation would be in the public interest. Studies have shown that deregulation has produced over $12 billion in annual benefits. Actually, based on the history of regulation, reregulation would simply strengthen the hand of the existing carriers and result ultimately in more, rather than less, monopoly pricing.

Policy Omissions

Unfortunately, the national transportation policy statement fails to discuss a number of important policy issues, in particular, subsidies to general aviation, the air traffic control system and the FAA, and the Corporate Average Fuel Economy (CAFE) standard. Of these, I have addressed the first two above, but CAFE warrants special attention.

While *Moving America* claims that "safety is the top priority for the Department of Transportation" and discusses a number of factors contributing to traffic deaths and injuries, the report fails to mention that small cars are much less safe than large ones, although Secretary Skinner recently acknowledged just that in a letter to Congress.

The CAFE standard requires automakers to market and sell enough high-gas-mileage cars to offset less-fuel-efficient vehicles to meet an average mileage standard. The most direct method to achieve this balance is to price their small autos low enough to ensure that a sufficient number will be sold to offset consumers' desires to purchase larger, safer, and more comfortable cars. As Skinner has admitted, however, the probability of surviving an accident is inversely related to the size of the occupant's vehicle. Nor is this simply a theoretical proposition. Studies by Brookings and Harvard scholars have shown that CAFE contributes to the death of about 2,200 to 3,900 drivers and passengers a year.

CAFE is promoted as a scheme to save energy, but it probably saves little if any energy. Drivers with fuel-efficient cars, which are cheaper to operate, are tempted to drive them more miles than owners of gas guzzlers. Since small cars are also less expensive than larger autos, more such vehicles are bought and driven. Large, less-fuel-efficient cars, on the other hand, will be driven

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farther and kept longer than if these large, safe cars were cheaper. Since new cars of the same size are normally more fuel efficient than older models, driving old cars longer uses more fuel. In other words it is unlikely that CAFE saves gasoline. The certainty is that it reduces safety.

Despite studies to this effect, one of Secretary Skinner's first acts was to require that auto companies attain a fleet average of 27.5 miles to the gallon for the 1990 model year. He even suggested that higher CAFE standards might be called for to "save the environment."

Conclusion

Moving America is better than I expected. It makes several good points, many of which were made by previous administrations. It fails to tackle the more difficult or controversial issues. The report accepts the conventional wisdom. If we recognize that government documents must be cleared through an interagency process that is bound to remove controversial proposals, we can conclude that this opus is "good enough for government work."

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Snake Oil in the SPR

A little iconoclasm may be in order as Congress, alarmed about rising oil imports, prepares to expand the Strategic Petroleum Reserve (SPR). Now a 600-million-barrel store of crude oil, accumulated at an average price per barrel substantially higher than the current price, the $25 billion SPR rests in underground salt caverns in Texas and Louisiana under the watchful eyes of Department of Energy (DOE) bureaucrats. It is problematic whether they will ever release it; they might as well be storing snake oil.

On February 1, 1990, the Secretary of Energy delivered a study to Congress that discourages expanding the SPR beyond its currently authorized 750 million barrels. Yet legislative proposals call for a SPR of one billion barrels, the goal chosen by the Carter administration; H.R. 3193, introduced in August 1989, would also add regional stockpiles and even stocks of oil products—to further increase our demand for imports from OPEC and other exporting countries. With reauthorization of the 1975 Energy Policy and Conservation Act coming up, this is a good time to reexamine the purpose and operation of the SPR and to expose some myths.

A fundamental principle of all analysis is that oil is a fungible commodity. An oil crisis, whether caused by an interruption in the supply network or a shortfall in world production, will manifest itself as a price increase to oil consumers everywhere. It is consumers—not nations—who compete with each other by bidding up the price. The world oil market "shares" an oil shortage by allocating the available oil to all those willing to pay the higher world price.

Myth #1: The SPR assures energy security in case of an embargo. This myth stems from the 1973 Arab oil "embargo" declaration, blamed at that time for shortages of gasoline that were really due to price controls and administrative misallocations; the embargo itself never reduced imports. An embargo cannot be effectively directed against the United States unless a naval blockade physically interdicts oil shipments to the East Coast, the Gulf, and the West Coast, including shipments from Alaska. (In 1988, U.S. refiners imported as much oil from Alaska as from the Persian Gulf.)

The real security threat is not a naval blockade, but sabotage and terrorist attacks against our oil refining and distribution system within the United States. The SPR cannot protect against these.

Myth #2: SPRs provide a cushion against supply shortfalls. Not quite true. As might have been anticipated, national SPRs reduce the incentives for private stockpiles. Refiners can now rely on government to carry the cost of stockpiles. If, in the future, stockpiles are set up for oil products, we can confidently expect that the level of private storage will drop. Taxpayers would then pay the cost, instead of oil companies.

Myth #3: An American-owned SPR benefits Americans. Not quite; remember that oil is fungible. Oil released from our SPR subsidizes foreign consumers by reducing a supply shortfall and thereby moderating a global price increase. As physical barrels of oil move from the SPR into U.S. refineries, they reduce the demand for imports and make more oil available to the rest of the world at a lower price. These truths have been stated repeatedly; they need to be reiterated here for the bene-

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fit of a new generation of bushy-tailed bureaucrats and politicians.

Thus, a cutoff of oil from the Persian Gulf would hurt all consumers, including Europeans and Japanese. We should keep this fact in mind as we review our military expenditures for the U.S. Central Command (started as the "Rapid Deployment Force" by Jimmy Carter)—especially as the Soviet strategic threat to the Gulf recedes. Its cost of over $40 billion per year, now borne only by U.S. taxpayers, far exceeds the SPR carrying cost of about $2.5 billion.

Myth #4: The SPR must store ninety days of imports. There is no rationale for this rule. The 90-day figure is reached by outdated modelling, a hangover from the days when the SPR was thought to be necessary to replace "lost imports" on a barrel-for-barrel basis. Further, for the sake of world equity, national stockpiles should be proportional to oil *consumption* rather than oil imports. Since oil consumers everywhere pay the same price (net of transport costs) in a free oil market, even exporting countries, such as Great Britain and Norway, should carry stockpiles scaled to their use of oil.

Myth #5: Oil will be released from the SPR in the event of an oil crisis. This pious hope begs several questions. What is an oil crisis? And, can anyone act in time to do any good? According to this myth, the president determines the presence of a crisis. Do not believe it. There exists no definition of what constitutes a crisis—such as a specified price increase on the world market. Through several administrations the DOE has steadfastly refused to define and announce a release policy. But one can visualize the many daunting steps required to release oil from the SPR. With the necessary proclamation drafted by a GS-15, with the spelling corrected by a deputy assistant secretary, with the assistant secretary seeking approval through the chains of command and Congress, with interagency coordination, and finally with international coordination involving also the State Department and the National Security Council—the crisis may well be over before the pumps start pumping.

Actually, it may never come to this. Bureaucratic incentives being what they are, there will be reluctance to release oil from the SPR—even during a "crisis." After all, suppose the oil is drawn down and the crisis has not abated? Yet no one will blame a prudent, highly risk-averse bureaucrat—and there are so many in the chain—for saving the oil for a rainier day.

Myth #6: The agreement to share oil through the International Energy Agency (IEA) will protect the consuming nations. The IEA was set up in Paris in 1974, based on the facile idea that since OPEC is a cartel, consumers should also form one. But a little reflection demonstrates that oil sharing makes little sense. One has only to ask the price of the oil that is to be shared. If it is the world price, then we do not need the IEA; the oil market provides an automatic sharing among those willing to pay the price. If, on the other hand, the price is to be at the (much lower) level existing *before* the supply crisis, then countries giving up oil from their SPRs are subsidizing the others. Thus, the sharing agreement, the main rationale for the IEA, is either useless or preposterous; it is also dangerous because it keeps alive the idea of oil allocation by political entities rather than by the market.

Myth #7: Releases from the SPRs must be coordinated by the IEA countries. This attractive-sounding proposal can actually cause severe problems, worsen the oil crisis, and delay or frustrate any action. Since the fundamental aim of SPR releases is to moderate a temporary price increase—that is, to achieve some measure of price stability—it is best to randomize release decisions. Even if coordination could be accomplished, it would reinforce a price swing—if everyone guesses wrong about the duration of the supply interruption. There is no advantage to coordination; countries that release their SPR oil would make money and could replace the oil later at a lower price. Countries that do not release oil would miss the opportunity to make money (unless the crisis persists); but their citizens benefit though lower prices no matter whose oil is released. (Remember the Fundamental Principle!)

What to Do?

We start from the fact that we now have a large government-owned stockpile. Its fundamental function, as we have discussed, is to reduce price peaks. Since we have to replace the oil, we can also fill in price valleys if we buy the oil when the price is low. One way to achieve these goals is to privatize at least part of the SPR by selling options: "call" options that permit the holder to buy oil at certain (high) strike prices and "put" options that require the SPR to buy oil from the holder at certain (low) strike prices. The selling of

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options provides income for the SPR; buying low and selling high can make it profitable *and* promotes price stability.

Beyond this, a publicly owned SPR does have the benefit of discouraging Congress from instituting price controls, rationing, or similar nonmarket allocation mechanisms for fear that speculators would profit from price swings.

The DOE report to Congress also included a study on financing an expanded SPR. The report recommends more of the same—on-budget purchases from general revenues—but opens up the option of "leasing." To some extent the study was stimulated by the idea that we could save money by leasing oil from Saudi Arabia and storing it in the United States. A report dating to 1976, prepared for then-Secretary of the Treasury William E. Simon, discusses a similar but less costly proposal. It points out that storing crude oil in the United States represents a unique opportunity for the Saudis by creating for them a financial nest egg out of reach of their enemies, without in any way upsetting OPEC—since the stored oil would not be marketed unless there were a supply shortfall and a corresponding price increase.

It makes sense for the U.S. government to permit the Saudis, and others with excess production capacity, to enter into private agreements with U.S. companies to store crude oil here. They can produce, transport, and store it at a cost of a few dollars a barrel and sell it for a large multiple at some future date of their choosing. All parties would benefit from such privatized oil storage—above all the United States, because it would remove the need to expand or maintain a large and costly government SPR financed by taxpayers.

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Unintended Consequences

The Probable Effects of Mandated Medical Insurance

Simon Rottenberg

Most Americans have some form of private or government medical insurance. As of late 1987, 147 million individuals were covered by employer-provided medical insurance plans. Another 34 million were covered by individual private insurance. In addition, the government finances medical insurance for almost all the elderly through Medicare and for about half of the poor through Medicaid.

But some 33 million Americans remain uninsured. The probability of having no medical insurance is higher for individuals employed only sporadically—such as part-time, seasonal, or temporary workers—and for young adults. Still, an estimated two-thirds of the uninsured are in households in which the primary earner is employed year-round, most of them full-time. The vast majority of these workers are employees of small firms in the retail trade, services, and construction industries. One study indicates that nearly 60 percent of the uninsured in Massachusetts are in families with an annual income of $20,000 or more.

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Not surprisingly, the uninsured use less medical service per person and per household than do the insured. This condition is consistent with several alternative interpretations. The uninsured may receive insufficient care. The insured may demand excessive care. Or individuals who expect to need more care may be more likely to be insured than their healthier neighbors. The available evidence probably reflects some combination of each of these conditions.

The Basic Health Benefits for All Americans Act

Congressional hearings on the plight of the uninsured have been carefully orchestrated. Committee staff identify poor, unskilled, uninsured families who are confronted by medical bills they cannot pay. A typical story includes a wife who has suffered a series of miscarriages and a recent high-risk pregnancy and one or more children who have endured a serious viral infection. Sen. Edward Kennedy and Rep. Henry Waxman have used such hearings to build a case that the uninsured are underserved by the medical market and have introduced into their respective houses of Congress the Basic Health Benefits for All Ameri-

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cans Act. This bill would require all employers to arrange medical insurance coverage for employees and their dependents. Proponents estimate that two-thirds of the currently uninsured would be newly insured through employer-sponsored plans if the legislation were enacted.

The Basic Health Benefits for All Americans Act would require all employers to arrange medical insurance coverage for all employees who work more than 17.5 hours per week and for their dependents. Benefits would include hospital care, physician care, diagnostic tests, prenatal and well-baby care, catastrophic coverage, and a limited mental-health care.

The proposed law would require that firms arrange medical insurance for all employees who work more than 17.5 hours per week and for their dependents. The bill defines a minimum acceptable package of medical health insurance benefits as one that includes hospital care, physician care, diagnostic tests, prenatal and well-baby care, catastrophic coverage, and a limited mental-health benefit. Employees could not be excluded from coverage because of preexisting health conditions. Annual direct costs to patients for covered services could not exceed $3,000 per family. Deductibles could not exceed $250 per individual or $500 per family, and deductibles would not be permitted for prenatal and well-baby care. Coinsurance could not exceed 20 percent. Employers would be required to pay 80 percent of the premium. For employees earning less than 125 percent of the legal minimum wage, employers would be required to pay the whole premium. Alternative cost-sharing and premium arrangements could be offered, but only if they were "actuarially equivalent or better than the minimum plan," and any acceptable alternative would have to include the basic required minimum benefits of the bill.

A system of six to eight insurance regions would be established. The Secretary of the Department of Health and Human Services (HHS) would "certify" acceptable regional insurers and insurance plans and options other than the one defined in the legislation. Insurers would not be allowed to base premiums on "age or gender of employees (or their families), [or] on other factors relating to the projected or actual use of health services under the plan." The legislation would allow insurers to charge premiums based on experience within particular "communities," but no community defined for the purposes of setting premiums could be smaller than the whole of a single state. Finally, the bill would provide for a public federal-state program to supply the minimum package of benefits to the poor who do not qualify for the mandated employer-based insurance.

There is disagreement over whether the coverage provided by the proposed law is miserly or generous. Congressional proponents generally argue that the bill would provide a "bare bones" package of mandated benefits, while opponents say it is excessively lavish. There is no doubt, however, that there would be pressures from suppliers of specialized medical services to expand the basic insurance package once it became law. For example, there are now some 690 state mandates that specify coverage that must be included in basic medical insurance contracts, whether the individual buying the insurance feels a need for them or not. These state mandates include wigs, herbal medicine, in-vitro fertilization, special diets for some gastroenterological diseases, treatment for Alzheimer's disease and for drug and alcohol abuse, the services of psychologists, psychiatric social workers, chiropractors, and nurse midwives. As with the current government medical insurance programs, the cost per person served is likely to increase over time.

The Impact of Mandated Medical Insurance

The Kennedy-Waxman legislation sounds like a simple enough solution to the problems facing individuals who lack medical insurance. Forcing employers to provide coverage would also allow Congress to offer assistance without adding substantial costs to the federal budget. But a more careful examination of the Basic Health Benefits for All Americans Act demonstrates that it would have a substantial negative impact on both the labor and the health-care markets.

Labor Markets. A requirement that employers provide a minimum medical insurance package to employees working more than 17.5 hours per week would reduce the number of jobs available, reduce money wages, and reduce the availability of other fringe benefits. These negative effects would fall disproportionately on the less-skilled,

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lower-wage segments of the work force. To understand these effects, it is useful to examine the market for labor services more closely.

Labor services are exchanged in markets where employers demand labor and workers supply it. The price at which an individual worker and a specific employer will strike an agreement is obviously determined by a myriad of forces. The price of labor is the entire compensation package: money wages and bonuses; paid vacations, holidays, sick days, and parental leave; life, health, and disability insurance; retirement plans; child-care assistance; educational aid; subsidized parking; a company car; and a whole range of other benefits. Firms that buy labor services are interested in the total cost of labor, in whatever forms payment is made, and employers are generally indifferent to whether an incremental dollar an hour is paid in cash or in providing a fringe benefit.

If all other things were equal, workers would prefer to receive their entire pay in the form of money wages. Money paid for labor services is not conditional upon the occurrence of a sometimes uncertain event such as the use of sick days or parental leave. In addition, money paid directly to workers, rather than to others who provide in-kind benefits, would allow each individual employee to determine the mix of goods and services that he finds most attractive. Thus, if all wages were paid in money, an employee could determine whether he wants to pay for parking near the office or ride the bus and purchase a new CD player with what he saves, for example. Money wages give workers the maximum individual choice in purchasing amenities they view as attractive. In-kind benefits, by contrast, foreclose choice; they must be used in the form provided or they are lost.

Because all other things are not equal, in-kind and conditional benefits constitute a large fraction of the compensation package of most American workers. The most important condition favoring in-kind benefits is the tax code. Cash receipts are subject to income tax, while the value of most fringe benefits is not. In addition, firms purchasing services for a large number of employees may enjoy economies of scale and buying power advantages that allow the firm to supply the service to each worker more cheaply than employees could manage if they purchased it individually.

Labor markets in the United States offer a wide variety of compensation packages. Some contain large money components with few fringe benefits, while others offer a substantial portion of employees' pay in the form of fringe benefits. Workers sort themselves among the competing employment opportunities open to them according to their preferences for money income versus in-kind income, depending on individual and family needs. For example, workers with small children may be attracted to a firm that offers child-care assistance. Workers who are strongly risk-averse or who expect to have higher than average medical bills may choose employment that offers a generous medical insurance plan as part of the payment for their services. Other workers may choose more paid vacation or more flexible hours. This freedom of choice allows employers and employees to arrive at the employment contracts that best satisfy both parties.

Given that the new medical insurance requirement would increase the price paid for labor by a substantial amount, adjustments would take place in other parts of the compensation package. Other fringe benefits could be reduced or eliminated. Adding required medical insurance coverage where it is not now offered could result in reduced paid holiday and vacation leave, for example. For at least some workers, less appropriate compensation packages would be offered and would force these workers to accept a contract that will make them worse off.

The most important condition favoring in-kind benefits is the tax code. Cash receipts are subject to income tax, while the value of most fringe benefits is not. In addition, firms purchasing services for a large number of employees may enjoy economies of scale and buying power advantages.

This is true even among firms that already provide medical insurance. Medical insurance plans vary widely across companies, in large part because the employees of different firms vary. Some firms employ mostly young workers, others tend to hire older individuals. Male employees predominate in some firms, while females predominate in others. For some firms turnover rates are high and for others low.

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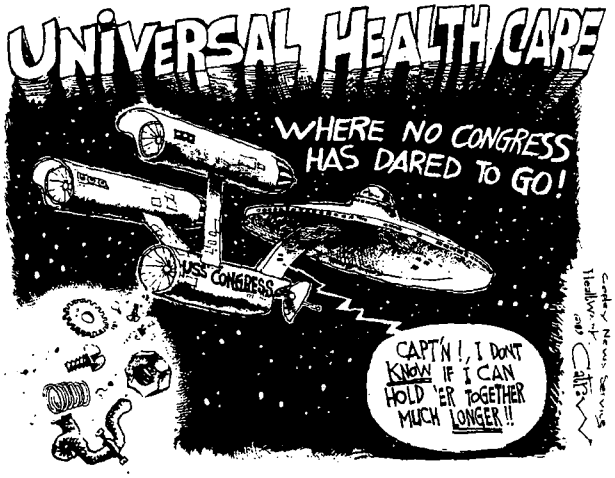
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The most appropriate medical insurance coverage and insurance financing arrangements depend in part on the characteristics of worker groups in each firm. The differences among industries and firms lead to nonuniform medical insurance packages. Plans vary with respect to types of treatment covered, dollar ceilings on benefits, percentages of medical costs paid by the insurance company, and deductibles and copayments faced by employees. Some firms do and others do not cover dental and vision treatment, treatment for alcohol or drug abuse, hearing care, hospice care, routine physical examinations, well-baby care, and routine immunizations and inoculations. Some employers provide continued medical insurance as part of their retirement packages, while others do not.

The proposed law would define minimum coverage and prescribe financing arrangements. This would reduce the rich diversity that now marks the market for employer-provided medical insurance. No HHS-sponsored certifying process designed to identify "actuarially equivalent" plans could possibly match the immense variety of plans available today.

The expected value of medical insurance varies among individuals. Neither illness nor its severity is uniformly distributed among workers. Some illnesses are concentrated among the very young and others among the elderly. The probability of events requiring a diagnostic and therapeutic response varies greatly among individuals and is affected by age, gender, and life style. When workers are permitted to exercise individual judgment, some conclude that premium payments subtracted from their money earnings are higher than the benefits they expect to receive, and employers offering medical insurance as an option have found that some employees choose to remain uninsured. One large firm that offered catastrophic coverage for which employees had to pay 25 percent of the premium found that only 2 percent of its workers elected to accept the coverage.

Mandated medical insurance is equivalent to an off-budget tax on employment. It is a cost imposed by law that does not produce revenue for the Treasury. Employers are told that they must provide insurance to their workers up to a mandated minimum standard, and workers are told that when they sell their services, they must accept payment, in part, in the form of medical insurance.

The proposed law prescribes that the lion's share of the premium cost is to be paid directly by the employer. From the economic theory of taxation, we know that the ultimate incidence of a tax is almost always different from its direct incidence. The fact that employers must pay at least 80 percent of the premium for all workers and the whole premium for low-wage workers does not mean that employers would bear those proportions of the insurance cost. How much of the premium cost falls upon employers and how much upon workers depends, in economic terms, upon the conditions affecting the demand for and supply of labor. Most of the effective differences are on the supply side of the labor market.

For most adult males, the amount of labor supplied appears to be nearly invariant to their wage rate. For this group, the primary long-term cost of mandated medical insurance would be a reduction of real wages—with little effect on employment.

By defining minimum coverage and prescribing financing arrangements, the proposed law would reduce the diversity that now marks the market for employer-provided medical insurance.

An increasing proportion of the labor force, however, consists of workers for whom the supply of labor is more "elastic" with respect to their wage rate. This group includes teenagers, working wives, those nearing retirement age, those for whom welfare is a close alternative, and all those

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whose wage is close to the minimum wage. For this group, the primary long-term cost of mandated medical insurance would be a reduction in employment—with little effect on the wages of those who remain employed. A primary effect of mandated medical insurance on those with a weaker attachment to the labor force, thus, would be to reduce the employment of this group.

There would also be efforts to avoid the proposed tax on employment by adjusting employees' work schedules. Because medical insurance would be required only for workers employed more than 17.5 hours each week, some employees would be encouraged to reduce their hours to fewer than 17.5. Indeed, some workers currently working full time might find it necessary to rearrange their schedules so that they are employed for fewer than 17.5 hours per week by each of several different firms. To the extent that such adjustments took place, the proposed law would generate transactions, transportation, and inconvenience costs.

Schedule rearrangements could also move in the opposite direction. Workers employed 17.5 hours per week would be covered by the same medical insurance benefits package as full-time employees. Thus, the additional cost imposed by the law would be higher for part-time employees on a per-hour-worked basis than it would for full-time employees. Employers would tend to prefer employees who could work substantially more than 17.5 hours. This would place at a disadvantage those workers whose life styles or competing responsibilities make it convenient to offer their services for only half a work week.

The additional cost imposed by the law would be higher for part-time employees than for full-time employees, and employers would tend to prefer employees who could work substantially more than 17.5 hours.

In sum, the costs of mandated medical insurance would be paid in fewer fringe benefits, lower money wages, and lower employment. There would also be reduced flexibility to establish work schedules. Finally, most of these costs would fall most heavily on the less-skilled, lower-wage segments of the work force.

Estimates of the total costs and employment effects of the Kennedy-Waxman proposal vary widely. One advocate of this proposal, Professor Kenneth Thorpe of the Harvard School of Public Health, estimates an annual cost of about $33 billion, with a loss of up to 100,000 jobs and $5 billion in tax revenues. An independent study of the probable effects of the Massachusetts plan estimates that this plan, when effective in 1992, will cost employers and colleges about $700 million and reduce employment by about 9,000 jobs (net of those that move to other states). On a national basis, these estimates are equivalent to an annual cost of about $29 billion and a loss of about 375,000 jobs; this estimate of the national cost is likely to be low, because Massachusetts has an unusually low percent of uninsured. Other estimates range up to $108 billion and one million jobs. Most of the job losses would be low-skilled workers employed in small firms. A survey by the National Federation of Independent Business suggests that this plan might cause as many as one-quarter of small businesses to close, and others would reduce employment by substituting other production inputs including foreign sourcing.

Health Care Markets. The market for medical care would also be negatively affected by the introduction of mandated medical insurance. In particular, medical care resources—the services of doctors, nurses, and other medical care professionals, clinic and hospital facilities, etc.—are likely to become overburdened. This increase in usage would come about because additional insurance and cross subsidies would encourage more intensive use of medical care resources.

In addition to obtaining medical insurance to protect against the cost of illness, many individuals exercise care in life-style decisions so that the probability of serious illness is reduced. Proper exercise, a nutritionally balanced diet, refraining from smoking, and not abusing alcohol or drugs, for example, all contribute to lower overall medical care costs for the careful individual. The introduction of mandated medical insurance would create a "moral-hazard" problem, however. Once insured, the behavior of an individual may alter because most of the costs of medical care are met by others. Thus, these costs may cease to affect the individual's life-style choices. At the margin, less care would be taken to avoid illness because the cost of illness would have been shifted to the insurance companies. The Kennedy-Waxman bill

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would prohibit insurers from varying premiums on the basis of age, sex, or other factors related to the use of medical services. Easily distinguishable groups, some of which would draw heavily on pooled funds while others draw only lightly, would pay the same premium rates for a given quantity of insurance. As a result, the young would subsidize the medical insurance of older workers; employees with few dependents would subsidize those with many; nonsmokers would subsidize smokers; and the prudent would subsidize the dissolute.

Of course, cross subsidies exist under current arrangements. No one can predict exactly which insured individuals will need to draw most heavily on their insurance plans. But insurers attempt to limit cross subsidies by taking into account certain variables—such as age, occupation, past medical history, personal habits, etc.—that offer some indication of expected future medical problems or the lack thereof. Such discipline would be substantially reduced under the Kennedy-Waxman proposal.

Cross subsidies also occur when medical care charges are not paid by patients or their insurers. The cost of unpaid medical bills are shared by uncompensated providers, philanthropic contributions, public appropriations, and insured patients whose premiums are raised to help cover the expenses of patients who do not pay.

Proponents of mandated medical benefits often argue that current subsidies are not "fair." But the proposed medical insurance mandate, particularly with the pricing restrictions it would impose on insurers, would increase the extent of cross subsidization. It is not clear that cross subsidies generated by the new law would be more equitable than those that already exist.

The extension of mandated medical insurance benefits and the increase in cross subsidies they would entail would increase the demand for medical services. At least some of the increase in demand would represent an inefficient use of society's resources.

Most illnesses are self-limiting. They are corrected by natural biophysical processes and by self-medication with nonprescription remedies. When medical care costs are paid out-of-pocket, the costs influence individual decisions about whether to visit a doctor. The more limited use of professional services that results helps reduce the overall costs of U.S. medical care.

Professional resources employed in the delivery of medical care are very costly. For example, self-care in the treatment of minor upper respiratory illness was found to reduce the cost of treatment by a factor of 15 from what it would have been if a visit to the doctor were required. The production of a physician requires costly training resources, and the delivery of medical care by physicians is very resource-intensive. When self-care relieves health care professionals of the need to treat self-limiting illness, it frees them to devote attention to patients who need their services more.

Insurance payments covered slightly less than half of all personal medical care expenditures as recently as 1965. In 1987 such payments represented about three-quarters of all such expenditures.

An expansive insurance plan reduces the incentive to distinguish self-correcting illnesses from more serious ones, and as a result, professional care is consumed more intensively under such systems. This increases the price of medical services to everyone.

Insurance payments covered slightly less than half of all personal medical care expenditures as recently as 1965. In 1987 such payments represented about three-quarters of all such expenditures. Nationally, medical expenditures represented 4.4 percent of the gross national product of the American economy in 1950. In 1987 medical expenditures accounted for 11.1 percent of gross output. Many conditions have contributed to the increased importance of medical services in the U.S. economy. These include the increasing fraction of the population that is elderly and subject to more serious illness, the discovery of new diagnostic instruments and therapeutic techniques that prolong life, and the growth of redundant diagnostic testing ordered by physicians to provide protection against liability. But the sharp rise in the proportion of gross output attributable to medical care can also be explained in part by the displacement of self-care by professional care in the treatment of many self-correcting illnesses.

In a recent year, primary-care physicians in the United States provided an estimated 472 million office visits. If only 2 percent of nonprescription drug consumers had chosen to seek professional care rather than to resort to self-medication, the

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number of patients would have increased to 721 million; the demand for the services of doctors would have risen by 53 percent. Thus, even trivially small fractional movements from self-medication to professional care would swamp the medical care system.

The Kennedy-Waxman bill would have substantial costs, and those costs would fall disproportionately on those people the bill was designed to help.

To charge "efficient" insurance premiums, a medical insurance provider needs to be free to assign individuals to proper risk categories. Risk categories or classifications are homogeneous enough when events that generate claims are randomly distributed among members of the risk class, that is when there is no further readily available information—personal habits or avocations, for example—that would lead the insurer to expect that some individuals within the group are more likely to draw on the insurance plan than others. Once proper risk categories are established, insurance premiums that cover expected outlays can be charged. Individuals who pay efficient insurance premiums in this sense will have the necessary incentives to take proper care in their personal habits and will exercise adequate judgment when deciding whether an illness or injury is serious enough to visit a doctor. But for the health care market to operate efficiently, individuals must be free to choose the amount of insurance coverage they will purchase, and the price paid for that insurance must be known to them.

Conclusion

The proposed legislation to mandate employer-provided medical insurance would distort the health care market on several scores. It would limit the ability of insurers to assign individuals to appropriate risk categories. The resulting cross subsidies would send the wrong price signals to consumers. The legislation would also limit the freedom of individuals to determine how much medical insurance they wanted to buy. Anyone working more than 17.5 hours would be forced to accept the government's mandated minimum. Finally, the price workers pay for the mandated insurance would be concealed from them as wages and other fringe benefits were adjusted to help cover the costs of the required insurance. Further confusing the issue is the fact that under the proposed mandates, wage adjustments would differ from firm to firm and from job to job.

Thus, the negative effects of requiring employers to provide a specified minimum medical insurance policy are substantial. Money wages and other fringe benefits would be reduced as a result. Jobs would be lost, including many "half-week" jobs. There would be pressure to reduce hours worked below 17.5 hours per week or to increase them substantially to spread the cost of medical insurance over more hours worked. These effects would fall disproportionately on the less-skilled, lower-wage employees in the most labor-intensive industries. Such adjustments would obviously make many workers worse off.

Mandating the expansion of medical insurance and specifying a minimum floor would also lead to more use of the nation's health care resources. Some individuals would take less care of their health because more costs would be borne by an insurer. More important, many self-limiting illnesses that are now treated at home would be brought to the attention of a doctor. This type of increased use would be wasteful of health care resources and facilities.

In short, the Kennedy-Waxman bill appears to address the problems created by a lack of medical insurance for some persons. A closer look reveals just how misleading this appearance is, however. The Basic Health Benefits for All Americans Act would have substantial costs, and the costs would fall disproportionately on those people the bill is designed to help.

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The Proliferation of Pension Regulations

Kathleen P. Utgoff

The proliferation of federal pension regulations, which accelerated in the mid-1980s, has undermined the incentive for employers to provide pension plans, particularly defined benefit pension plans. The proportion of workers covered by a defined benefit plan has declined substantially, and few new private defined benefit plans are being created. This has both reduced the ability of employers to structure long-term work arrangements and shifted more of the investment risk of providing retirement benefits to the individual worker. The proliferation of pension regulations, much of which was designed to reduce risk to covered workers, has had the unintended effects of limiting the proportion of workers covered and of increasing their risks.

Background Conditions

Since 1970 there has been a dramatic trend toward early retirement. While legislators were working to make sure that no one was forced to retire, older workers and not-so-old workers left the labor force in droves. The labor force participation rates for two groups of male workers—age 65 and over and ages 55 to 64—fell a full percentage point per year between 1970 and 1985. Now, less than 15 percent of males over 65 are in the labor force and only two-thirds of males between 55 and 65 still work.

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Some of this pattern can be explained by large, unanticipated increases in Social Security benefits, but that is not the only explanation. Richard Ippolito's study of retirement behavior points out that much of this reduction can be explained by changes in the early retirement provisions of private pension plans. In 1960 only 8 percent of workers covered by a pension could retire with full benefits before age 60, by 1983 over half could.

Given that our changing demographics have begun to produce a dearth of new workers, it is easy to imagine that personnel managers across the country are being called on to undertake a major overhaul of their pension plans to encourage later retirement. For the most part, however, the scene in corporate boardrooms and executive offices is totally different. Executives who are responsible for pensions are busy explaining the expenditure of hundreds of thousands of dollars on actuaries who were hired to perform thousands of calculations to prove that a firm's current pension plan is in compliance with the law. This executive must then admit that these expenditures do not even buy peace of mind. Pension laws are changed every year. To make matters worse, practical details of those new laws are left to three different federal agencies to implement through regulations. But many of these regulations have never been published, although the penalty for noncompliance can be retroactive and draconian.

It is not surprising then that severe myopia and fixation with detail have immobilized corporate benefit departments. Many dedicated executives

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cannot think about the future; they are too busy trying to understand, comply with, and explain hundreds of detailed and artificial constraints that must be met to maintain the tax-exempt status of pension plans.

Many of these beleaguered executives remember a time when a pension was a way to provide retirement income to long-service employees and a way to influence turnover that increased overall productivity. But managers cannot talk to their benefit consultants about the needs of employees or the firm any more. As the secretary of the retirement committee at Loyola University told *Institutional Investor* magazine, "I've been in the pension business twenty years, and we're reaching the point where I can't even understand my actuary." A host of new laws has made pension design an increasingly tedious maze. Although the reward for passing through the maze is a substantial tax benefit, many employers are deciding the price is excessive. The percentage of workers covered by a pension, which grew fairly steadily since World War II, has come to a virtual standstill.

To understand how pension plans came to be so restricted in a nation that is worried about a low savings rate as well as an aging population, it is important to distinguish between restrictions that were intended to prevent fraud or protect workers and those that were intended to redistribute income. Although the business community fought both types of regulations and predicted dire consequences for both, it is the regulations that have tried to redistribute income among sex, age, and income groups that have proved to be the most disruptive and burdensome. There is a new wave of legislation on the horizon, however, that threatens to be equally disruptive. This legislation is based on the misguided notion that pension plans, as major owners of corporate securities, have a negative impact on our economy.

All pension regulations are conditional mandates. No employer is required to establish a pension plan. But if a plan is established, several requirements must be met to obtain the tax breaks afforded to "qualified" plans.

Antifraud and Worker-Protection Rules

The primary purpose of the Employee Retirement Income Security Act of 1974 (ERISA) was to prevent fraud and the loss of pension benefits when a business failed. Toward that end, ERISA established requirements to ensure that employees did not have to work for excessively long periods to qualify for a pension. Discharges to prevent the collection of pension benefits were prohibited. Fiduciary rules governing the behavior of people exercising control over the management and investment of pension plans were established. Plans were also required to spell out plan provisions in a written document and to provide information to employees that described the rules of the plan, the financial status of the plan, and benefit accruals under the plan.

Although there is no evidence that ERISA reduced behavior that could be considered fraud, probably because pre-ERISA fraud was rare, the antifraud provisions did not create the regulatory nightmare that exists today. There was an initial spate of plan terminations when ERISA became effective because some employers refused to continue plans under the new rules, but otherwise there were relatively few major complaints once the dust settled.

One continuing source of contention has been the treatment of excess assets in a defined benefit plan. These plans promise a monthly benefit that is usually related to length of service and pay levels. Unlike a defined contribution plan, where, once the worker has worked long enough to vest, the assets always belong to the employee, the assets in a defined benefit plan are like a bond that backs the promise of a monthly benefit. If the employer terminates a defined benefit plan and buys an insurance contract for all promised benefits, any extra amount in the fund reverts to the employer.

To understand how pension plans came to be so restricted in a nation that is worried about a low savings rate as well as an aging population, it is important to distinguish between restrictions that were intended to prevent fraud or protect workers and those that were intended to redistribute income.

Sen. Howard Metzenbaum, the AFL-CIO, and the American Association of Retired Persons (AARP) believe that asset reversions constitute fraud and that excess assets belong to workers. Business groups point out that employers would

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minimize assets in pension plans if they were forced to give excess assets to workers. They also believe that employers should be allowed to keep any excess assets because they are required to make up plan investment losses if assets are not adequate to pay benefits.

The debate over excess assets has raged for more than six years now, with no end in sight. So far, Congress has been unwilling to restrict employer rights to assets once benefit promises have been satisfied.

Congress has made major changes to pension law every year, and many of these changes were designed to alter the distribution of pension benefits among sex, age, or income groups to ensure that they receive the appropriate amount of benefits and a "fair" share of the tax breaks.

There is little disagreement, however, that one part of ERISA was seriously flawed. ERISA established the Pension Benefit Guaranty Corporation (PBGC) to provide federal pension insurance. The program was designed very poorly. Troubled employers were allowed to underfund their pension plans and then dump their plan liabilities on the PBGC. Bigger and bigger plans were forced on the PBGC to the point where the agency had a $4 billion deficit in 1986. Two major changes in ERISA were required to achieve some stability in the pension insurance program. The Single Employer Pension Plan Amendments Act of 1986 and the Pension Protection Act of 1987 made pension dumping much more difficult and introduced better financial incentives into the program, such as a premium that is related to the amount of underfunding in the plan. The latest annual report of the PBGC indicates that these reforms are working.

Redistribution Rules

Because of the huge sums that are held in pension plans and the substantial tax breaks accorded to pensions, Congress has turned increasingly to pension law to achieve social objectives or to ensure that pension tax benefits are distributed "fairly." Since the mid-1980s, Congress has made major changes to pension law every year, and many of these changes were designed to alter the distribution of pension benefits among sex, age, or income groups. The basic assumption is that without a host of complex rules, low-income groups, women, and the elderly would not receive either the appropriate amount of pension benefits or a "fair" share of the tax breaks given to pensions.

Sex. Some of the recent changes in pension law were designed to increase pension benefits provided to women. The Retirement Equity Act of 1984 is the most notable example of legislation with this goal. Although career patterns for women have changed dramatically over the past 20 years, pension law was redesigned to make sure that the work patterns of the 1950s and 1960s do not deprive women of pension rights. The vesting period has been reduced in many plans from 10 to 5 years, and new rules have been established to protect pension rights during leaves of absence. In addition, pension plans must now offer a form of life insurance so that benefits are paid to the spouse if a worker dies before retirement; and spousal consent is now required before a worker can take a higher monthly benefit in lieu of continued benefits to a surviving spouse. Although these changes were supposed to increase the pension benefits of women as a class, the net effect may have been just the opposite—an increase in the number of women working in jobs where there is no pension coverage.

Age. The congressional spotlight has also turned on the pattern of pension accruals over a working career. Many pension plans were explicitly designed to encourage retention of younger workers and to encourage retirement among older workers. That practice has now become suspect as a form of age discrimination and is under heavy attack by groups that lobby on behalf of the elderly. In 1986 Congress passed new rules that require the accrual of benefits for older workers beyond the normal retirement age. In addition, a much broader attack on pensions as a workforce management tool is now moving through Congress. Following a recent Supreme Court decision (*Public Employees Retirement System of Ohio* v. *Betts*), which recognized the broad exemption in the Age Discrimination and Employment Act for employee benefit plans, Congress has sought to restrict this exemption. Mrs. Betts, who lost disability benefits when she became old enough to

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qualify for a smaller pension benefit based on her few years of service, presents an extremely sympathetic case. But the legislation that has been introduced since the *Betts* decision goes much further than is required to prevent a decline in total benefits as a worker grows older.

On February 28, 1990, the Senate Labor and Human Resources Committee passed the Older Workers Benefit Protection Act (S. 1511), which restricts the coordination of pension, severance, and disability benefits. Many companies offer a package of different benefits, and the components of that package vary as the worker gets closer to retirement; younger workers who are not yet eligible for a full pension are entitled to higher severance or disability payments, and older workers are entitled to a bigger pension. These coordinated plans were designed to make sure that all workers had at least a modest level of income if they lost a job because of a plant closure or permanent disability.

The AARP has argued that parts of a benefit package should never be reduced because of age and that pension benefits should always increase with age. S. 1511 is a major step in that direction. The bill also calls into question two other important features of many pension plans: early retirement benefits and window period benefits, where employers offer increased retirement benefits to a limited class of workers for a limited period. Under the circumstances, it is easy to understand the concern that a misguided war on all age-related compensation would eliminate many of the benefit programs that have been designed to deal with job loss in a humane and equitable fashion.

Income. By far, the most complex and disruptive rules governing pension plans are the rules that are designed to assure that pension benefits are distributed fairly across income groups. These rules govern the design of the plan, contributions to the plan, and payments from the plan. To comply employers must decipher numerous and often inconsistent sections of the Internal Revenue Code and IRS regulations to answer basic questions of who is the employer, who is an employee, and what is compensation. In addition, highly compensated employees must be identified under a host of alternative definitions, involving numerous tests and several salary levels. Some of these tests require that members of the same family be treated as one employee. All of these tests require esoteric and complex distinctions with little or no economic merit: What is a separate line-of-business? What is a leased employee?

This regulatory complexity penalizes both employers and employees. Individuals must follow complex distribution, roll-over, and lump-sum averaging rules to avoid tax penalties. A tax is imposed if the payments from the pension plan begin too early, if they are too late, or if the amount received is less than the prescribed amount. In addition, the total distribution cannot be "too large," even if the plan has exceptional investment returns. These rules, which are detailed in hundreds of pages and tables, are hopelessly complex and confusing. When even the experts are confounded by pension rules, it is clear that individuals cannot adequately plan for a retirement that is not jeopardized by significant tax penalties.

The most complex and disruptive rules governing pension plans are the rules that are designed to ensure that pension benefits are distributed fairly across income groups. These rules govern the design of the plan, contributions to the plan, and payments from the plan.

One set of rules that has raised numerous complaints covers the extent to which employers can take Social Security into account when they set benefit levels. This now-restricted practice, known as Social Security integration, makes a great deal of economic sense. Employees certainly take Social Security into account when they plan for retirement. Moreover, because Social Security replaces a higher fraction of income of low-wage workers, a desirable pension plan from both the workers' and the employers' standpoint is one that replaces a smaller fraction of the income of low-wage workers relative to better-paid workers.

But Congress views Social Security integration as discriminatory toward low-income groups and has limited the extent of integration considerably. To offer a pension to anyone, employers are sometimes forced to provide pensions to some workers that would lead to higher levels of income in retirement than during the working years. To make matters worse, the rules that define allowable integration are virtually impenetrable and constantly evolving.

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Given the likely behavioral response to unwanted savings forced through the private pension system, the complex Social Security integration rules are probably costly detours at best. Economic research confirms that workers pay for pension benefits through lower wages. We also know that it is relatively easy for many workers to alter their savings and borrowing behavior in response to changes in their private pensions. What happens, then, to a low-income worker when his pension is increased because of the new Social Security integration rules? First, the take-home pay of the worker is reduced, and second, the worker reduces other savings or increases borrowing to compensate. Because of these responses, there may be little or no change in lifetime income or consumption during retirement. Thus, although the Social Security integration rules have been designed to redistribute income through the pension system, the most likely impact is an increase in costs borne by workers and costs borne by firms. Workers are forced to pay additional costs to achieve desired life-cycle patterns of consumption. The costs of obtaining a home-equity loan are, for example, more than trivial. In addition, firms pay substantial costs in redesigning and communicating new pension plans.

Unfortunately, the example of Social Security integration is not unusual. Virtually all of our pension laws have been passed under the assumption that individuals and labor markets do not adjust when new pension laws create artificial constraints. To the contrary, there is a strong belief that pension laws can be used to change the distribution of income and that tax incentives can be used to alter fundamental compensation and consumption patterns. To date, there is not a shred of evidence to support this belief, yet it remains a fundamental tenet of our national pension policy.

A New Wave of Regulations

Efforts to redistribute income through our pension system will undoubtedly continue, but there is also a new wave of pension legislation on the horizon that threatens to be equally troublesome. Now that pension plans have assets that exceed $2 trillion, pension funds have become a tempting target and a source of funds for schemes that are completely unrelated to retirement objectives.

Whenever there is an economic controversy, pension funds immediately appear on the front lines as either victims or villains or both. After the stock market crashed in October 1987, attention was quickly focused on pension funds; they were thought to have caused the crash by engaging in suspect activities such as index arbitrage, portfolio insurance, or program trading. Another widespread belief in the early aftermath of the crash was that the decline in stock values had jeopardized retirement income. Neither of these concerns turned out to be valid, but nonetheless there have been repeated calls for restrictions on pension plans to increase market stability or to improve the performance of the economy.

One example of this perspective can be found in a bill (S. 1654) introduced by Sens. Nancy Kassebaum and Robert Dole. Under this bill, known as the Excessive Churning and Speculation Act, pension plans would pay a tax on all gains from assets held less than 180 days. The bill was designed according to Sen. Kassebaum "to encourage pension funds to adopt a better long-term strategy."

Whenever there is an economic controversy, pension funds immediately appear on the front lines as victims, villains, or both. There have been repeated calls for restrictions on pension plans to increase market stability or to improve the performance of the economy.

Proponents of the bill believe that corporate managers cannot make the investments that will allow the United States to compete in global markets unless they are protected from the short-sighted demands of pension-fund managers who allegedly flee from a stock whenever long-term investments are announced.

Although there is plenty of hard evidence that refutes this fable of pension myopia, the belief that we need to be protected from pension plans persists. The premise behind the Kassebaum-Dole bill received wide support at a hearing before the Senate Finance Committee in March 1990. Even Treasury Secretary Nicholas Brady applauded the goals of the bill, although he opposed the excise tax as a way to achieve those goals. Instead, Brady believes that a change in pension law is more appropriate to prevent pension funds from endangering capital formation.

Secretary Brady's position provides little comfort to professionals in the pension community.

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Opposed to any change in pension law after virtually continuous legislative turmoil, pension professionals are especially leery of a change that would allow pension funds to be used for anything other than retirement security. If pension plans are used as a tool to promote investment in capital equipment and R&D, can investments in the infrastructure, the environment, or union-approved companies be far behind?

Pension funds have also been implicated in the controversy over corporate restructurings. Pension funds are viewed as unstable ballast in our economic system that careens from one set of managers to the next in a takeover battle to pursue the "quick buck." Pension funds have also been charged with fueling the junk bond market that finances takeovers. Here again, pension plans are not only villains, but victims. Many pension plans have excess assets, and these plans are seen as irresistible to corporate raiders when they hunt for takeover targets.

Congressional hearings revealed that LBOs were not driven by pension funds and that pension funds gained from investments in LBOs and other restructuring activities, but the belief that something needs to be done persists.

Eight separate committees of Congress held 21 days of hearings on leveraged buyouts (LBOs) in 1989. These hearings revealed that LBOs were not driven by pension funds and that pension funds gained from investments in LBOs and from other restructuring activities. But even though the facts exonerated pension funds, the belief that something needs to be done persists.

Shortly after the LBO hearings, Congressman Peter Visclosky introduced legislation that would force a major change in the way pension plan investment decisions are made to address "concerns over the pernicious effect of leveraged buyouts." The Visclosky bill would create an equal number of worker and management trustees for all pension plans and consequently, an administrative quagmire that could ensnarl the management of funds that own nearly one-fourth of all corporate equities and 40 percent of corporate bonds.

Antitakeover pension legislation has also been introduced in the Senate. Three Democratic senators recently introduced an amended version of antitakeover legislation that has been pending for several years. The bill (S. 2160) would prohibit the use of surplus pension assets to finance a takeover, either directly or indirectly. In addition, the bill would amend ERISA to prohibit a plan from earning more than 30 percent of its income from shares held less than three months. One of the ironies of the 30-percent rule is that it is likely to increase rather than decrease the turnover of stock in pension funds. The rule already applies to mutual funds. When a mutual fund experiences large short-term gains that violate the 30-percent rule, it sells shares that have been held more than three months to increase the proportion of measured (realized) income from "long-term" investments.

These bills are only a few examples of the new wave of pension legislation that is bound to continue. Congress will turn to pension plans to find a cure for many problems, both imagined and real, because, as Willie Sutton said when asked why he robbed banks, "That's where the money is." Moreover, it is much easier and safer for Congress to blame pension plans for economic problems than it is to reexamine tax and spending policies that are more likely to be the real culprits.

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Effects of Pension Regulation

Constant change in our pension law means that employers must frequently amend pension plans and communicate these changes to employees. Although the promise of a pension should be a stable, long-term contract between an employer and a worker, in the current environment it is very difficult for either side to rely on or even understand the terms of the contract.

The regulatory complexity that results from constant change also makes it very difficult if not impossible to demonstrate compliance with the law. Substantial resources are consumed in the compliance process that could be devoted to retirement benefits for employees.

Often, major pieces of pension legislation have been passed as a part of huge budget bills. Pension provisions are added to budget bills because they raise revenue by restricting contributions to pension plans. Frequently, no hearings are held on the proposed changes, and the negative effects of the new laws are rarely explored before passage.

The result of this process, which is driven by revenue needs rather than a sound retirement policy, is described by the Association of Private Pension and Welfare Plans, a trade association that supports employee benefit plans: "[T]here has been no concern for simplicity, nor has there been an attempt to create a logical structure to the law. Often, new legislative proposals fail to recognize prior provisions addressing the same issue, resulting in an incomprehensible array of irrational rules. As a result of this failure to consider overall structure, efforts to strengthen the laws have simply led to a patchwork of overlapping, duplicative, or inconsistent provisions creating an environment in which compliance is nearly impossible and in which penalties for failure to comply with all the rules are substantial."

Defined benefit plans have been particularly hard hit by recent legislation. While many defined contribution plans are little more than tax-deferred savings accounts, a defined benefit plan is a complex contract that usually offers higher, more predictable benefits. The employer bears the investment risk, and because the benefit is paid as an annuity, the worker is also relieved of the worry that the pension will not last until he dies. It is much easier to plan for retirement when one's company offers a defined benefit plan.

In theory, the defined benefit plan also offers unique advantages to employers, primarily the ability to encourage workers to stay or to encourage them to leave. Until 1974, an unfunded (pay-as-you-go) defined benefit plan could also be used to give workers a strong incentive to make sure that the firm is profitable—much like an employee stock ownership plan.

But the advantages of defined benefits to the employer have been eroded by recent legislation. Rules that cover vesting for young workers and accrual for older workers have been changed to reduce sharply the utility of a defined benefit plan as a workforce-management tool. Federal pension insurance as well as new minimum funding standards that have been adopted to protect the insurance program mean that unfunded benefits can no longer be used to induce higher productivity. In addition to these changes, the maximum amount that an employer can put in a defined pension plan has also been reduced. These changes reduced employer flexibility with respect to annual contributions and reduced the tax advantages of defined benefit plans for employers who were funding at the old maximum limits.

Defined benefit plans have been particularly hard hit by recent legislation. A defined benefit plan is a complex contract that usually offers higher, more predictable benefits than a defined contribution plan.

All these changes have reduced the attractiveness of defined benefit plans to employers. Statistics on the type of plan offered to employees reflect this effect (see Figure 1). In 1980 the primary pension plan for 83 percent of workers with a pension was a defined benefit plan. By 1987 that figure had dropped to 68 percent. While the number of unduplicated active primary pension plan participants rose from 35.9 million to 41.9 million over this period, the number covered by defined contribution plans increased from 6.2 million to 13.4 million so that the number covered by defined benefit plans did not increase.

Some of this decline in defined benefit plans can be explained by shifts in employment patterns away from the manufacturing industries that typically offer defined benefit plans. But

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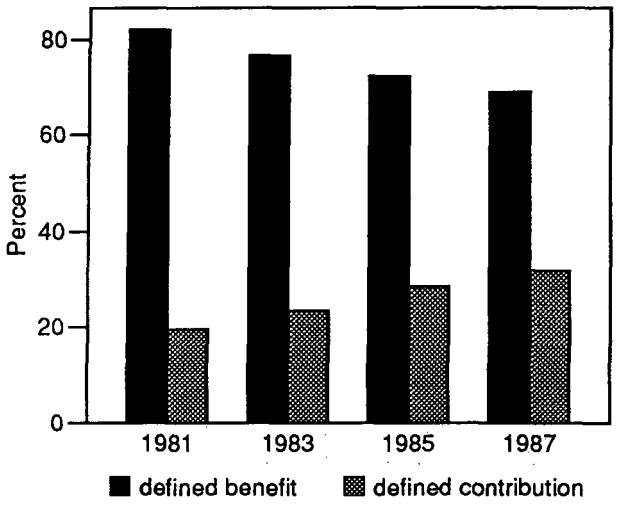
Figure 1: Primary Plan Coverage: Defined Benefit vs. Defined Contribution (percentage of participants)



Source: Pension Benefit Guarantee Corporation's *Annual Report* (1989).

much of this change is attributable to a decline in the probability that any given employer will adopt or continue a defined benefit plan. The decline in defined benefit plans is particularly apparent among small employers, and this pattern implicates regulatory overload as one of the causes of the decline. The costs of the new regulations, particularly the cost of achieving and proving compliance, are relatively fixed and consequently put a heavier burden on smaller plans.

Many pension experts believe that the decline in defined benefit plans is not consistent with sound national retirement policy. Defined benefit plans offer at least two distinct advantages in providing retirement security. First, the assets in defined benefit plans yield higher rates of return than the assets in defined contribution plans, because investments in defined contribution plans are often directed by workers, who have lower tolerances for risk than firms. The Employee Benefit Research Institute reports that the annual real rate of return over the past five years for defined benefit plans has been nearly two percentage points greater than the rate of return for defined contribution plans. Second, defined contribution benefits are also distributed as lump sums, which makes retirement planning more costly and difficult because reserves must be set aside to cover the contingency that the worker will live an unusually long time. These reserves are unnecessary for most recipients of defined benefit pensions because benefits are usually paid out as annuities. And, most important, the investment risk of providing an expected pattern of benefits is borne by the employer, not the individual worker.

Defined benefit plans are not better for everybody; young mobile workers often prefer defined contribution plans. But the choice of pension plans should be made on the basis of what is best suited to the interests of firms and workers; it should not be determined by taxes or regulatory burdens. Moreover, we cannot assume that employers will continue to bear the added risks associated with defined benefit plans if they are denied any of the advantages. Many of the legislative reforms of the past few years can be characterized as an attempt to give workers the advantages of defined benefit plans without the mobility constraints and other features that make these plans attractive to employers. The decline in defined benefit plans is one indication that there is a significant cost that has been imposed by regulatory and legislative turmoil. Some workers no longer have the opportunity to earn a generous and secure defined benefit pension.

Many pension experts believe that the decline in defined benefit plans is inconsistent with sound national retirement policy. While defined benefit plans are not better for everyone, the choice of pension plans should be made by what is best suited to the interests of firms and workers. It should not be determined by taxes and regulatory burdens.

Conclusion

Our private pension system is being battered by continuous change in our pension laws and a stream of complex and contradictory regulations. Part of the problem is that the pension system is being used in a vain attempt to redistribute income and to achieve other political objectives. Another problem is that we have no structure for evaluating the cost and benefits of increased pen-

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Of the three, it is my favorite	29.6	42.5	25.9
Read regularly (at least 3 out of 4 issues)	57.2	68.2	53.0

Source: 1989 Market Facts, Inc.

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sion regulation. Too often it appears that the goal of restrictions on our pension system is to prevent any opportunity for perceived abuse, with no weight given to the cost of these restrictions imposed on employers and recipients of pension benefits. In fact, our current budget accounting measures the impact of increased regulations as an increase in tax revenues that results from lower contributions to pension plans. How can we not have too much regulation if we use this framework?

We need to reexamine our goals to determine whether they can and should be achieved through our private pension system. It is time to stop pruning the trees and look at the forest. If we do not, our nation's population may grow older without adequate resources to meet our retirement needs.

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Why WARN?

Plant Closing Legislation

Ronald G. Ehrenberg and George H. Jakubson

In July 1988 Congress passed the Worker Adjustment and Retraining Notification Act (WARN), which requires firms with 100 or more employees to provide workers, the state government dislocated worker unit, and local government officials with written notice 60 days before a planned shutdown or large-scale layoff. Although Congress had considered legislation calling for advance notice every year since 1979, 1988 was the first year that such legislation passed both houses of Congress. President Reagan, although philosophically opposed to the legislation, bowed to election year political pressure and did not veto the law. WARN went into effect on February 4, 1989.

In addition to advance notification of plant closings, WARN requires covered employers to give 60 days' notice of a layoff that is planned to last at least six months that involves either 500 or more workers or at least one-third of the employer's workforce. Coverage is not universal, however. In addition to not covering small firms, the law exempts firms from the advance notice requirement for a number of reasons: for example, if the firm is actively seeking ways to avoid the shutdown (such as trying to find a buyer for the business), if business circumstances that could not be "reasonably foreseen" force the dislocation (however, notice is required at that point), if a natural disaster directly causes the shutdown or mass layoff, if the firm relocates within a "reasonable" commuting distance of its previous site and offers employees jobs at the new location, if the workers to be displaced were hired with the understanding that their employment was limited to the duration of a particular project, or if a planned layoff of less than 60 days is extended due to "unforeseeable" circumstances. In each of these cases, the burden of proof is on the employer to show that he warrants an exemption.

Penalties for failure to provide the required advance notice include back pay and benefits for each displaced worker for each day of violation and a fine of $500 per day for failing to notify local government. The law is designed to be enforced through law suits filed in a federal district court by employees, a union, or a local government. Unlike other forms of labor market regulation such as the Fair Labor Standards Act (governing minimum wages, overtime premium, and child labor) and the Occupational Safety and Health Act, the U.S. Department of Labor has no enforcement authority under WARN.

WARN was passed only after a decade of strenuous debate, and two years after its enactment it is useful to consider a number of issues it raised. What benefits did proponents feel would arise from advance notice legislation and what costs did opponents perceive? What type of public policies toward advance notice do other nations have? Did displaced workers in the United States receive advance notice before WARN became law? What do we know empirically about the ac-

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tual effects of advance notice on workers and firms? What has experience under the first year of WARN taught us? Finally, what research should be conducted to determine whether WARN is a good idea and what alternative public policies might help facilitate the provision of advance notice to displaced workers?

Hypothesized Benefits and Costs of Advance Notice Legislation

Proponents of advance notice requirements argue that they ease displaced workers' shock and facilitate their search for alternative employment or additional training. Notifying government agencies allows them lead time to mobilize their resources to assist displaced workers. Indeed, a companion piece of legislation to WARN, the Economic Dislocation and Worker Adjustment Assistance Act specifically requires the Department of Labor to fund programs for states to aid dislocated workers and to create dislocated worker units that counsel workers about alternative employment and new training.

Advance notice also allows employers, workers, unions, and local government to collaborate to determine whether there are ways to prevent the plant closing or layoffs. Such measures include wage concessions by the workers, tax concessions by the local government, restructuring of the work environment to improve productivity, or seeking new ownership, including employee ownership.

Proponents of advance notice requirements argue that they ease displaced workers' shock and facilitate their search for alternative employment or additional training and allow government agencies lead time to mobilize their resources.

To the extent that advance notice facilitates workers' transition to new jobs or helps to avert workers' displacement, proponents argue that it benefits local communities as well as individual workers. Plant shutdowns and massive layoffs place extra demands on communities for social services, as the stress induced by unemployment causes an increased incidence of physical and mental ailments while local sales and property tax revenues are reduced.

Opponents of advance notice legislation argue that it will restrict the free mobility of capital, increase worker turnover, and decrease productivity. They also argue that advance notice will decrease the likelihood that buyers of the plant's product will place new orders, that banks will supply new credit, that suppliers will continue to provide services, and that the firm can sell the plant to potential buyers. (The latter explains one of the exemptions under WARN.) In addition, they believe that advance notice may depress corporate stock prices and that by effectively increasing the cost of reducing employment, it can encourage firms *not* to expand employment or to substitute overtime hours for additional employment.

Critics of WARN and similar legislation object to the fact that the advance notice is mandatory. Proponents respond that in the absence of mandatory advance notice very few displaced workers will actually receive such notice; evidence we cite below suggests that the proponents are probably correct on this point.

In evaluating the case for advance notice legislation, it is important to stress that for two reasons an employer does not bear the full social cost of the plant shutdown or mass layoff. First, because the unemployment insurance system is financed in the United States by an imperfectly experience-rated payroll tax, an employer's unemployment insurance payments will increase by less than the unemployment insurance benefits his displaced workers receive. Second, an employer typically does not take into account the costs that a mass layoff or plant shutdown imposes on the community. Consequently, proponents of advance notice requirements argue that the legislation helps internalize these external costs, and that by implicitly increasing the cost of plant closings or mass layoffs, employers will be discouraged from taking such actions. Meanwhile, critics stress that anything that implicitly or explicitly increases labor costs will encourage the flight of jobs overseas.

Advance Notice Legislation before WARN in the United States and Abroad

Most European nations have legislation requiring employers to notify employees about to be laid off or fired. The length of notice required typically depends on whether the individual is a white-col-

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lar or blue-collar employee and on his prior length of service with the firm. The advance notice required in these countries ranges from 1 week to 24 months. When large-scale layoffs or plant shutdowns are contemplated, European law also typically requires firms to notify unions and government and to work with employees and government representatives to attempt to avert the displacement. Often European law requires severance pay for displaced workers, and some countries, for example, Sweden, have detailed programs of labor market services including retraining, job placement, public works jobs, and wage subsidies to facilitate labor market adjustments. In many European countries small establishments with fewer than 100 employees are exempt from advance notice requirements, perhaps to avoid imposing additional costs on small businesses (which typically have high failure rates) or to account for the fact that a failure of a small business does not have a substantial negative effect on a community.

Both federal and provincial laws in Canada similarly require advance notice, which typically depends on an individual's length of service with the employer. Furthermore, the length of advance notice required typically exceeds the 60-day requirement of WARN.

Serious debate about an advance notice requirement began in the United States during the deep recession of the mid-1970s. The large number of plant closings and permanent layoffs in major manufacturing industries that followed increased interest in advance notice legislation. As has often been the case with other forms of government regulation of conditions of employment in the United States, action by states preceded federal action.

As of early 1988, there were only a few state laws relating to advance notice in the United States. Maine, Wisconsin, and Hawaii required advance notice of plant shutdowns (with size class exemptions). Maine also required one week's severance pay per year of service for workers with more than three years of service. The penalties for noncompliance were low in Maine ($500 per establishment) and Wisconsin ($50 per employee), but high in Hawaii (three months' wages and benefits per laid-off worker). Connecticut did not require advance notice, but did require nonbankrupt firms to maintain health insurance and other benefits for up to 120 days for workers unemployed because of plant shutdowns. Massachusetts, Maryland, and Michigan had voluntary programs in which firms were urged to provide advance notice or to continue benefits. Finally, South Carolina "required" employers to give workers two weeks' notice before shutting down, but *only* in situations where employees were required to give advance notice before quitting.

Before WARN became law, displaced workers in the United States could have received advance notice of a pending layoff or plant shutdown if they lived in a state in which such notice was required, if a collective bargaining agreement required notice, or if an employer voluntarily chose to provide advance notice.

Often European law requires severance pay for displaced workers, and some countries have detailed programs of labor market services including retraining, job placement, public works jobs, and wage subsidies to facilitate labor market adjustments.

Three employee-based surveys have recently collected information about the fraction of displaced workers who received advance notice. These were the *Survey of Displaced Workers* supplements to the January 1984, January 1986, and January 1988 *Current Population Surveys* (*CPS*), the monthly national probability sample of the population from which our unemployment and labor force statistics are derived. These supplements covered workers who were displaced during the 1979–1983, 1981–1985, and 1983–1987 periods, respectively.

Table 1 presents data on the proportion of displaced workers in these surveys who received advance notice or who expected layoffs. For the purposes of this table, we define displaced workers as individuals who worked for the same firm for at least three years before permanently losing or involuntarily leaving a full-time job. These data, presented in the first three rows of the table, suggest that over half of those workers displaced during the 1979–1987 period received advance notice or expected their layoffs. Thus, at first glance, it appears that a substantial fraction of displaced workers in the United States received advance notice before WARN became law.

We should note, however, that the question,

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Table 1: Proportion of Displaced Workers Who Received Advance Notice or Expected a Layoff in the January 1984, January 1986, and January 1988 *CPS* Displaced Worker Supplements

January 1984 Survey (workers displaced in 1979–1983)	.56
January 1986 Survey (workers displaced in 1981–1985)	.55
January 1988 Survey (workers displaced in 1983–1987):	.58
Received written advance notice	.20
Received written notice of less than 1 month	.06
Received written notice of 1 to 2 months	.05
Received written notice of 2 or more months	.07
Received written notice but failed to report length	.02
Expected a layoff	.38

Source: Authors' calculations from U.S. Bureau of Labor Statistics Bulletin 2240, *Displaced Workers 1979–83* (Washington, D.C.: July 1985), U.S. Bureau of Labor Statistics Bulletin 2289, *Displaced Workers, 1981–1985* (Washington, D.C.: September 1987), and tables from a forthcoming bulletin governing the 1983–87 period.

"Did you receive advance notice or expect a layoff?" does not distinguish between a worker's receiving a formal written notice and his simply seeing the "handwriting on the wall." Similarly, the question elicits no information about the length of advance notice. This is a crucial shortcoming because the effectiveness of advance notice policies in preventing displacements and easing workers' transitions presumably depends partially on how far in advance the notice is given.

Fortunately, the January 1988 survey, which covered workers displaced during the 1983–1987 period, also specifically asked displaced workers whether they had received formal written advance notice. If individuals answered affirmatively, they were also asked whether the notice was less than one month, one month to less than two months, or two months or more. The answers to these questions are tabulated in the bottom rows of Table 3.

Quite strikingly, only 20 percent of these displaced workers reported receiving written advance notice, and most of these reported receiving relatively short advance written notice. Indeed, only 7 percent of the displaced workers reported receiving written notice two or more months before they lost their jobs. Thus, it seems clear that before the passage of WARN, only a small fraction of displaced workers actually received the 60 days' written advance notice that WARN now requires. Studies recently conducted by the Bureau of Labor Statistics and the General Accounting Office of employers who had laid off a substantial number of workers confirm this conclusion.

Does Providing Displaced Workers with Advance Notice Matter?

Studies of the effects of legally mandated, collectively bargained, or voluntarily provided advance notice before the passage of WARN have been of two types. The first looks at the effects of advance notice on employment-related variables at the national or community level. One study that used aggregate data from 23 countries over the 1956–1984 period found weak evidence that advance notice requirements tend to increase the fraction of the population employed but decrease their average weekly hours. The author attributed these findings to the fact that many nations with advance notice laws exempt firms from notifying part-time employees, with the result that employers substitute part-time for full-time employees.

Before the passage of WARN, only a small fraction of displaced workers actually received the 60 days' written advance notice that WARN now requires.

WARN was designed to reduce the possibility of such substitution. Although part-time employees who work fewer than 20 hours a week are not counted under WARN in determining whether a firm has at least 100 employees, covered firms are required to notify part-time employees.

Another study examined the effects of plant closings in Maine before enactment of that state's law. The researchers found that when a firm voluntarily provided at least one month's advance notice, the closing's impact on the local area's unemployment rate in the month of closing was significantly reduced. While this result may be due to more rapid reemployment of displaced workers in the presence of advance notice, the researchers also found that advance notice was associated with a significant reduction in the size of the local labor force in the month of the closing. This latter result probably reflects either individual decisions to withdraw from the labor force or to move to other areas to seek employment.

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The researchers were unable to ascertain which had occurred.

The second, and by far the more numerous, type of studies examines the effects of advance notice on individual displaced workers and their employers. For example, one early study of 32 plant closings in the United States in the late 1950s and early 1960s found that voluntarily provided advance notice rarely led to increased quit rates or decreased productivity of workers.

More recently, many authors, including ourselves, have used the January 1984 and January 1986 survey data to analyze the effects of advance notice. On balance, these studies suggest that providing advance notice significantly increased the likelihood that a displaced worker would not experience any unemployment. That is, advance notice provided time for some workers to find a new job before their date of displacement. These studies also suggest that once an individual experienced any unemployment, the presence of advance notice had no effect on his ultimate duration of unemployment. Advance notice seemed to help, then, only if individuals found employment before displacement. In addition, these studies suggest that receipt of advance notice appeared, for the most part, to have no effect on subsequent earnings once a displaced worker was reemployed. Finally, among the people in the surveys who received advance notice, there was no evidence that a firm's most productive workers were more likely to quit before the displacement date and thus disrupt the firm's operations in its final weeks.

All of these conclusions, however, were based on analyses of the 1984 and 1986 data in which respondents were asked only whether they "received advance notice or expected layoff." Data from the January 1988 survey suggest that most people who responded affirmatively probably did *not* receive formal written notice and that most of those who did received relatively short advance notice. A recent analysis of the 1988 data suggested that formal written notice increases the likelihood that an individual will avoid unemployment, but that the magnitude of the effect of advance notice is smaller than when the broader definition of notice found in the 1984 and 1986 studies was used. Clearly, it is not written advance notice per se that determines a worker's success at finding reemployment, but rather whether, on the basis of his general perception of the likely future of his employer, he has made an effort to search for new employment. Written advance notice will matter only if it provides new information to the worker about his future employment prospects.

Early Experiences under WARN

WARN has now been in effect for slightly over a year, and while it is too early to evaluate the law formally, conversations with U.S. Department of Labor personnel and staff at the state dislocated worker units provide broad insights about how it is faring. Compliance with WARN appears to be high. WARN does not affect manufacturing firms primarily. In addition, WARN does not affect a substantial proportion of permanently laid-off workers.

Compliance. Unlike many other types of protective labor legislation, enforcement of WARN takes place through suits filed by employees, unions, or local governments in federal district courts, not through an office in the Department of Labor. Consequently, there is no central office receiving complaints about noncompliance, and hard evidence is difficult to obtain. State dislocated worker units, as well as the Department of Labor, receive numerous inquiries from unions and employees who feel they should have received advance notice, but often it appears that the employers probably were not required to file notice because (typically) their small size or the size of the layoff exempted them from the law.

Early experience with WARN shows that compliance appears to be high, that WARN does not primarily affect manufacturing firms, and that WARN does not affect a substantial proportion of permanently laid-off workers.

Even in cases where employers are not legally required to provide advance notice, they often do so. Of the 167 advance notifications received by Pennsylvania's DWU during the period from WARN's enactment through January 9, 1990, only 117 were from employers who were legally required to provide notice: about 30 percent of the notifications received were not required under the law. (This pattern was not observed in some of the other states we contacted.)

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Why would employers who do not have to comply with WARN do so? One possibility is that the debate surrounding the legislation caused many employers to reevaluate their vision of a "good employer." A second possibility is that the law is so complex and ambiguous that employers are simply trying to protect themselves. The penalties for noncompliance are so high (up to 60 days' back wages and benefits) that many employers may be deciding that it is cheaper to comply than to risk being found guilty of a violation.

The percentage of workers receiving advance notice under WARN is low because there are a number of exemptions under WARN and because WARN covers only plant shutdowns and mass layoffs.

As a result, although a number of individuals and unions have indicated to state and federal personnel that they intend to file suits for noncompliance, the number of suits actually filed has been small. As of early January 1990, state DWU personnel in several Northeastern and Mid-Atlantic states knew of no law suits being filed in their states, and the solicitor's office of the Department of Labor knew of only eight to ten cases in progress throughout the country. Although it is possible that the cost of pursuing lawsuits has discouraged some aggrieved parties from filing claims, on balance it appears that compliance with WARN is high. This should be contrasted with the relatively high noncompliance rates that researchers have found for the minimum wage and overtime pay premium provisions of the Fair Labor Standards Act, where the penalties for noncompliance and the likelihood of being caught are both quite low.

Affected Groups. Contrary to popular opinion, WARN is not affecting solely or even primarily manufacturing employers. Available statistics from the second half of 1989 indicate that only 27 percent of the notifications in Pennsylvania were from manufacturing firms. During the same period less than 40 percent of the notified displaced workers in New York State came from manufacturing; the majority had been employed in wholesale trade, retail trade, finance, insurance, and real estate, and other service-sector jobs. Although the public debate over advance notice requirements focused on our supposedly declining manufacturing base, WARN affects a much larger range of industries.

Still WARN does not apply to a substantial proportion of permanently laid-off workers in the United States. During WARN's first 11 months, from February 1, 1989 to December 31, 1989, there were 127 advance notifications involving 22,822 workers in New York State. Meanwhile, there were 657,247 new claims filed for unemployment insurance benefits, and 490,889 first payments were made to unemployment insurance recipients. (The difference between new claims filed and first payments reflects individuals who found new jobs within a week as well as those who were determined to be ineligible for benefits because they were dismissed for cause or quit their jobs rather than were laid off.)

Even if we ignore the fact that some workers covered by WARN notifications may have found jobs within a week of their displacement (prior studies suggest about 10 percent of them probably did), workers involved in WARN notifications represented only 4.6 percent of all new unemployment insurance recipients in New York. Even if half of these recipients were only temporarily laid off and were waiting to be recalled by their employers, less than 10 percent of permanently displaced workers in New York received advance notice under WARN.

This percentage is so low for two reasons. First, as noted above, there are a number of exemptions under WARN, including firms employing fewer than 100 workers. Second, unlike the laws prevailing in Canada and many European countries, WARN covers only plant shutdowns and mass layoffs so that advance notice for layoffs of individuals or small numbers of employees is not required in the United States.

Implications for Future Research and Public Policy

Past empirical studies do suggest that advance notice may facilitate labor market adjustments by allowing displaced workers to find new employment before they are fired or laid off. Advance notice thus appears to reduce the probability that displaced workers will suffer any period of unemployment, and thus it may moderate temporary increases in area unemployment rates. Moreover, virtually all past studies have counted as "ad-

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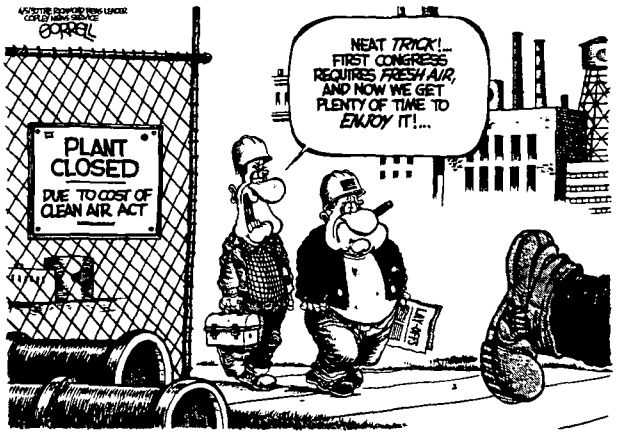
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vance" notice even notice of very short duration. Thus, their results may understate the effects of mandated notice of longer duration that is accompanied by the other supportive services that WARN requires. Furthermore, the data used in most of the studies were based on responses by individuals and did not consider whether advance notice can lead to actions (e.g., reorganization, wage concessions, or employee ownership) that help avert displacements.

Although opponents of advance notice cite the potential costs of such policies, empirical studies have found no evidence either that advance notice causes firms' most productive workers to leave or that the productivity of the remaining workers suffers. Moreover, except for one study that used aggregate multinational data, no systematic empirical evidence has been provided on the other potential adverse effects of advance notice that opponents have enumerated.

Although at first glance this suggests support for WARN, several cautions are in order. First, the effects of voluntary provision of advance notice when workers expect impending displacement may be very different from the effects of mandated advance notice when workers are not expecting the displacement. All of the research conducted for the United States so far has used data that predated WARN. Future research will need to analyze data from later periods when WARN was in effect. Since WARN requires advance notice only for large-scale displacements in large firms, researchers will need to distinguish the effects of WARN from the effects of being part of a large-scale displacement from a large firm. In addition, to estimate adequately the effects of advance notice per se will require researchers to model what displaced workers' expectations of displacement would have been in the absence of advance notice. Put another way, researchers will need to estimate whether formal advance notice actually communicates new information to workers.

Second, the observation that voluntary advance notice appears to reduce the probability that a displaced worker will suffer any unemployment does not necessarily imply that mandated advance notice will increase employment and decrease unemployment rates overall. It is possible that situations may develop in which displaced workers compete for a fixed number of vacant positions. Those workers who receive advance notice will enjoy an advantage, but concomitantly, the probability that workers who failed to receive notice will find jobs will be diminished. Thus, the gains to workers who received notice would come solely at the expense of those who did not. There would be no social gains from advance notice as it would not influence aggregate employment levels or unemployment rates.

The observation that voluntary advance notice appears to reduce the probability that a displaced worker will suffer any unemployment does not necessarily imply that mandated advance notice will increase employment and decrease unemployment rates.

Studies that use data generated by individual workers' responses, such as the *Survey of Displaced Workers*, cannot test for the possibility of such effects. The only study of U.S. data that addressed this issue found evidence that voluntarily provided advance notice led to smaller temporary increases in area unemployment rates. But the one study of cross-country data found no positive effects of mandated advance notice on aggregate employment levels and unemployment rates. Clearly more studies focusing on the effects of advance notice on area economic outcomes are needed.

Suppose for a moment, however, that all voluntarily provided advance notice actually does is "reshuffle" jobs among displaced workers from those people who fail to receive notice to those who do receive it. In fact, such evidence might strengthen the case for mandated notice if the people who receive voluntary notice need such

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assistance the least. For example, if before WARN was passed it was high-wage, unionized workers who were more likely to receive notice than comparably skilled, lower-wage nonunion workers (which some data suggest was the case), then implementation of WARN would allow the latter a "better shot" at competing for the available jobs when they are displaced. WARN could be desirable policy, then, because of its potential redistributive effects, even if it is expected to have no net effect on aggregate employment or unemployment.

To the extent that advance notice is a desirable policy, we should consider policies that encourage employers to voluntarily provide advance notice to exempted employees.

Third, it is important when designing a policy to be clear about the problem being addressed. If the major concern is the costs imposed on a local community by a plant closing or large-scale layoff, then public policy should specifically address this concern. While such a concern may argue for an advance notice requirement, exemptions from notice requirements should be based on the size of the displacement relative to the local labor market, not on the absolute sizes of the displacement and the employer, as is currently done under WARN. In contrast, if the source of the concern is the private costs workers suffer from displacement, then requirements for advance notice of individual displacements or severance pay provisions similar to those that exist in many European countries might be worth considering.

It is also worth reemphasizing that the data suggest that only a small proportion of permanently displaced workers in the United States actually receive advance notice under WARN because the law exempts small employers and small-scale or individual layoffs by large employers. To the extent that advance notice is a desirable policy, we should consider policies that encourage employers *voluntarily* to provide advance notice to exempted employees. For example, the federal government could fund a share of the unemployment benefits received by notified workers or reduce the corporate profit tax rates of firms that voluntarily provide advance notice to displaced workers.

Finally, well-designed research is needed to more adequately address issues relating to the overall labor market effects of WARN, including whether advance notice of impending displacement can help prevent displacement from occurring, as proponents of the legislation often assert. Because so much past research has focused on the potential benefits of advance notice legislation, subsequent studies of WARN should also focus on the potential costs of the law and other issues of concern to opponents.

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Morality on the Cheap

The Americans with Disability Act

Richard V. Burkhauser

The Americans with Disability Act (ADA), passed by the Senate in 1989 and by the House in 1990, promises to provide protection against employer discrimination. Under this act employers must make "reasonable accommodations" to disabled workers unless this would result in "undue hardship" on the operation of business. The legislation specifies examples of reasonable accommodations: job restructuring, part-time or modified work schedules, and reassignment to vacant positions. The legislation also explicitly includes provision of qualified readers, sign interpreters, or attendants for travel as examples of reasonable accommodation.

There are four main titles of the act. Title I incorporates the standards of discrimination set out in regulations implementing section 504 of the Rehabilitation Act of 1973, but will dramatically extend them to eventually include all employers of 15 or more workers. Title II extends the act to state and local governments. Title III covers access of customers in places of public accommodations such as restaurants, hotels, grocery stores, and other similar establishments and buses. Title IV covers accommodation in telephone services and telecommunications relay services. Each component of the act will have important implications for the American economy. Here I shall concentrate only on Title I.

The term "disability" is used in this act to mean: "(1) a physical or mental impairment that substantially limits one or more of the major life activities of such individual; (2) a record of such impairment; or (3) being regarded as having such an impairment." There was a heated debate in the Senate with respect to which impairments were to be included. For example, drug addiction was included in the original bill but specifically excluded in the final Senate bill, as were some rather esoteric, at least to this writer, sexual disorders. Because data on health conditions, let alone the numbers of people "who may be regarded as having such an impairment," are not available, no one knows how many people will eventually be covered by this act. The committee report claims that as many as 41 million Americans would be covered.

One source of data on the disabled is the *Current Population Survey*. On the basis of this survey, Haveman and Wolfe estimated that around 10 percent of the working age population aged 18 to 64—approximately 15 million people—were either on a government-provided disability program or claimed to have a health condition that limited the amount or kind of work they could perform. Table 1, which is based on Haveman and Wolfe's work, traces the economic well-being and earnings of disabled men over the past

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Table 1: Relative Well-Being and Work Effort of the United States Disabled Population, 1962–1984

	1962	1968	1973	1976	1980	1982	1984
Family Income[a]	n.a.	.74	.80	.80	.73	.66	.72
Earnings[b]	.61	.66	.74	.66	.58	.51	.54

Source: Compiled from Haveman and Wolfe (1990).

[a] Ratio of real equivalent family income of disabled men to that of the families of nondisabled men.

[b] Ratio of real earnings of disabled men to that of nondisabled men.

three decades. The family income of disabled men has been consistently below that of able-bodied men. The relative income of disabled men grew during the 1970s, peaked at 80 percent in 1976, and fell substantially during the early 1980s. Similarly, the wage earnings of disabled men rose to about three-quarters of the able-bodied male earnings in the early 1970s but have fallen substantially since then and were barely one-half those of able-bodied men in 1984.

Hence it is not surprising that policymakers should focus on ways of increasing the work opportunities of the disabled. Unfortunately, the principal charm of this act appears to be its ability to provide some help to the disabled at no cost to the federal government. The costs to the economy of the accommodations firms would be obligated to make under this act have not even been estimated, and the impact of the act on employer-employee relations has also been given little consideration.

Guaranteeing Equal Access to a New Protected Class

The historic civil rights legislation of the 1960s showed our commitment to ending discrimination based on race or sex. Federal intervention was justified as a means of guaranteeing equal justice, equal opportunity, and equal access to all citizens. Over the next two decades that commitment led to major government intervention into the private sector to redress discrimination. Government policy toward the disabled changed in the 1970s on the basis of a similar commitment to use civil rights legislation to integrate disabled people into an able-bodied society.

Health conditions lead to functional limitations that may or may not lead to the ability to perform in a job. This will depend on both an individual's health condition and the structure of the job. Functional limitations in themselves do not limit individual productivity. For instance, if the rules of basketball stipulated that the game was to be played by persons sitting in chairs with wheels, paraplegics would probably be highly productive players.

Public policy toward the disabled in the 1970s was marked by the acceptance of the proposition that the disabled represent a distinct minority group, in the same way that blacks and women are considered groups who are subject to economic discrimination. That is, disabled people possess characteristics that distinguish them from other members of society, and on the basis of these characteristics, they may be discriminated against. Furthermore, just as one would not cure racial discrimination by making blacks white, the solution to the problems the disabled face does not lie in reducing the functional limitations of the disabled but in mandating changes in the network of private relationships that prevent this minority from being fully integrated.

The ADA is a compromise from the extreme view that accommodation for all jobs is a right possessed by workers regardless of their impairment. Hence, while this legislation extends coverage of protection against discrimination under the Rehabilitation Act of 1973 to private employers, it also contains language that explicitly recognizes that substantial expenditures may be necessary to accommodate the disabled fully and that this type of accommodation is different from that necessary to integrate blacks or women into the marketplace. Thus, employers are obliged to make only *reasonable* accommodations that would not create *undue hardship* on the operation of business.

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Despite the recognition that costs rather than irrational discrimination might prevent complete

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CONGRESS, THE 1990 DISABILITIES ACT AND THE NEWLY DISABLED.
1990 DISABILITIES ACT
COSTS AND LITIGATION
(GASP) MEDIC!
SMALL BUSINESS
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accommodation of the disabled in the marketplace, the test for discrimination in the act is one of "disparate impact," not "disparate treatment." Hence employers would bear the burden of proof that job requirements that impact disproportionately on the disabled are essential to the job. The plaintiff need not show that an employer intended to discriminate, but must merely show that such actions differentially affect the newly protected class—the disabled. Passage of this act will force all covered employers to bear the cost of either abandoning such job requirements or preparing documented evidence of their necessity.

But the definition of "undue hardship" is perhaps the most troublesome feature of the ADA. In a competitive marketplace a laborer is hired if the additional revenue he is likely to bring the firm exceeds the cost of employing him. This economic concept of comparing costs and benefits is not the one suggested in this act. Rather a "deep pockets" criterion appears to apply. Those firms that will not be unduly harmed by the cost of accommodation are obliged to provide it. In the hands of imaginative lawyers, whose fees are subject to payment by unsuccessful defendants, this could grow to be a substantially open-ended obligation for firms to share their wealth with the disabled regardless of the actual relation between the productivity of the disabled worker and the costs of accommodation.

It is not difficult to make an argument that low-income disabled workers deserve help. But it is far from obvious that the burden of this help should be assigned in this way. Traditionally we have used the tax system to redistribute income and have not required firms to employ workers whose value to them is less than their cost to the firm.

The ADA leaves it to the courts to determine the degree to which firms are required to subsidize work by the disabled. The major political appeal of this method of redistributing income is that it does not explicitly raise taxes or increase the federal budget. But it has substantial costs that would still be paid by someone—the public. The cost will appear in higher prices and lower earnings, reflecting not only the higher production costs resulting from accommodation but litigation costs to determine on a case-by-case basis exactly what constitutes an undue burden.

Nonetheless, this system might make sense if there were substantial evidence that the great majority of employers are refusing to accommodate the disabled when their value to the firm exceeds the cost of accommodation. This evidence would lead one to argue for close supervision from the courts to end such practices. But no systematic evidence of this type of behavior was presented at the ADA hearings. In fact, the entire picture of the disabled at the hearings and in the popular press appears to be far off the mark.

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Who Are the Disabled?

The vast majority of people with health impairments were able-bodied workers for most of their lives. The recognition that disability is a *process* is critical to those interested in increasing labor force participation of the disabled. Despite the use of a wheelchair as the symbol of the disabled and the high profile of the sight- or hearing-impaired in the battle for disability rights, few of the disabled are blind, deaf, or in need of wheelchairs. Table 2 summarizes the recent data on the characteristics of the disabled. There were about 2.8 million people receiving Social Security Disability Insurance at the end of 1987. Nearly two-thirds of them were between ages 50 and 64. Among this older group, circulatory diseases (es-

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Table 2: Characteristics of Disability Insurance and Supplemental Security Income Recipients

Diagnostic Groups	All Beneficiaries			Newly Enrolled		
	Below 50	50–64	All	Below 50	50–64	All
Disability Insurance						
Mental Disorders	33.7	14.6	21.4	47.7	15.0	29.7
Circulatory Diseases	7.6	27.2	20.2	7.4	25.9	17.6
Musculoskeletal Diseases	11.9	21.7	18.2	6.4	16.4	13.1
Neoplasms	2.8	3.9	3.5	8.7	16.1	12.8
All Others	44.0	32.6	26.7	30.1	26.6	26.8
Total	100.0	100.0	100.0	100.0	100.0	100.0
Total (millions)	.99	1.78	2.77	.19	.23	.42
Total (percent)	35.7	64.3	100.0	53.7	46.3	100.0
Supplemental Security Income						
Mental Disorders (other than retardation)	26.0	19.9	24.1			
Mental Retardation	35.4	8.4	26.9			
Circulatory Diseases	2.8	20.2	8.2			
Musculoskeletal Diseases	3.3	16.0	7.3			
Neoplasms	1.7	2.3	1.9			
All Others	30.8	33.2	31.6			
Total	100.0	100.0	100.0			
Total (millions)	1.57	.74	2.31			
Aid to the Blind (millions)	.04	.02	.06			
Total All Programs (millions)	2.60	2.54	5.14			
Total Aged 18–64 (millions)	2.28	2.54	4.82			

Source: Derived from tables in the *Annual Statistical Supplement of the Social Security Bulletin* (1988).

pecially heart conditions), musculoskeletal diseases (especially arthritis), mental disorders, and neoplasms (i.e., cancer) accounted for two-thirds of all conditions. For the disabled under age 50 mental disorders alone accounted for one-third of all cases.

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Older clients dominate the disability insurance program, in part, because most recipients remain on the rolls until they die. But the picture does not greatly change if one looks at the newly enrolled in a given year. Table 2 also shows the characteristics of those who first came onto the disability insurance rolls in 1986. About 420,000 people did so, and almost one-half were aged 50 and over. Almost three-quarters of these older enrollees had one of the four previously discussed conditions. Of the younger workers, almost one-half suffered from mental disorders.

The other major financial aid program for the disabled is Supplemental Security Income. Started in 1974, this program provides means-tested benefits to those whose disabilities are severe enough to qualify for disability insurance benefits but whose previous work history is not sufficient to make them eligible to receive these benefits. More than 2.3 million people were on the supplemental income roles at the end of 1987. Mental disorders are the most common health condition for these recipients. Retardation is the major component of mental disorders for the young and is an important component for those aged 50 to 64.

The prognosis for the disabled to return to work has traditionally been poor. The sad prospect is that few people currently receiving either of these benefits will ever return to work. Some people argue that the benefits from these programs are

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sufficiently generous that they dramatically reduce the incentives to work. If this were the case, one would expect that those people who were denied disability insurance benefits would quickly return to work, but Social Security Administration studies of rejected applicants in the 1970s found extremely low labor force participation rates for unsuccessful applicants as well. Recently, Bound reviewed data from the 1978 Survey of the Disabled and found that just under 30 percent of rejected disability insurance applicants were employed and only about two-fifths of them were working full time.

This should not be very surprising. Disability is often a process; veterans of the disability insurance system, both successful and unsuccessful, are at the end of that process. We can infer from Table 2 that most health conditions first affect an individual's ability to work in the last two decades before normal retirement age. Quite often, disabled workers have had substantial experience in the labor force. Their health condition may be acute—a heart attack or stroke, which then requires a period of rehabilitation—or chronic—arthritis, which eventually leads to a reduced ability to work.

Whether an impaired worker returns to the job after an acute health emergency or continues on the job as a chronic condition worsens bears little resemblance to the decision to work of those who have long since left the job they held when their impairment first occurred. A successful disability insurance recipient must have been unable to work in any "substantial gainful activity" for a period of five months, and he cannot expect to be able to work for at least one year.

As Table 2 shows, there are fewer than 3 million people on the disability insurance rolls and fewer than 5 million people aged 18 to 64 on all transfer programs targeted specifically at the disabled. This is far fewer than the 41 million disabled who are claimed to be covered under the ADA or the 15 million whom Haveman and Wolfe count as disabled. There may be, however, a large number of working-age people with serious work limitations who are not currently receiving benefits. For such workers, acceptance on the disability insurance rolls would mean eligibility for substantial disability benefits. For instance, Haveman, Halberstadt, and Burkhauser estimated that a worker with a wife and two children who earned median wage income over his lifetime would replace 85 percent of his predisability after-tax income with disability insurance benefits. If his earnings were twice the median, disability insurance would replace 54 percent of his predisability after-tax income. Net wage replacement is somewhat smaller for workers without dependents—49 percent for the median wage worker and 35 percent for the worker earning twice the median.

Table 3: Allowances and Applications for Disability Insurance, 1970–1985

Year	Allowances (thousands)	Applications (thousands)	Ratio
1970	350	870	.40
1975	592	1284	.46
1980	397	1264	.32
1985	377	1169	.32

Source: Derived from the *Annual Statistical Supplement of the Social Security Bulletin* (1987, Table 60).

But applying for disability benefits has become an increasingly risky gamble. As Table 3 illustrates, in the 1980s the number of allowances per year was considerably lower than the number of applications. In 1985 only about 3 applicants in 10 were deemed eligible to receive benefits. Applicants for benefits must "invest" in not being able to work to maximize their chances of receiving benefits, and the review process can last for several years. It is not surprising that workers, especially older workers who have invested in not working for years, find it difficult to return to work even when they fail to become eligible for benefits.

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Keeping individuals who have just become health-impaired on the job is much more malleable to public policy. For those who would like to see the disabled continue to work, the good news

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Table 4: Employer Responses after Onset of Employee Health Condition[a] (percentages)

	No Help	Help	All
Did Employer Help[b]	70	30	100
Worked after Onset[c]	54	94	67
Current Labor Force Participation	41	59	47
Applied for Disability Insurance	59	36	52

Source: *1978 Survey of Disability and Work.*

[a] Sample includes 348 men aged 59 or younger who have a health condition that limits their current work activities and who were aged 21 or over and employed at the time this condition began to limit their ability to work.

[b] Response to "Did your employer do anything to help you out so that you could stay at work?"

[c] Response to "At the time your health condition started to limit your ability to work, did you stay with the same employer?"

about the ADA is that it focuses on the importance of accommodation in the workplace as the critical issue in keeping health-impaired people on the job. Thus, it offers some hope of mitigating the adverse effects of health impairments on the ability to continue working, and may reduce the number of applications for disability benefits.

The bad news is that the ADA's insistence on a disparate impact test was made with little information on the way that firms are currently accommodating the disabled. It appears that proponents of the ADA are more interested in assigning blame than in encouraging more accommodation in the marketplace.

Information on employer-employee relations is difficult to gather, and this is especially true for the disabled. In deciding to pass the ADA, the Senate relied solely on anecdotal evidence. But national data on the disabled are available. Through the 1970s the Social Security Administration fielded national surveys of the disabled. Unfortunately, scheduled surveys in the 1980s were cancelled owing to lack of funding, so that the most recent evidence comes from the 1978 Survey of Disability and Work. Table 4 provides information on 348 men who suffered a health condition serious enough to limit their ability to work. Thirty percent had employers who provided some help so that they could stay at work. Of those workers, 94 percent stayed on the job after the onset of their disabling condition, while only slightly over one-half remained on the job without their employers' help. These data were retrospective so that we are also able to look at what workers were doing at the time of the survey, which in many cases was years after their work impairment first occurred. Almost two-thirds of workers who received help from their employers were still working, while less than one-half of the others were still employed. Finally, only about one-third of those workers who received help applied for Social Security Disability Insurance benefits. Almost 60 percent of the others applied for such benefits.

Using more sophisticated econometric analysis, Burkhauser and Kim show that the greater the portion of predisability income replaced by disability insurance, the faster an impaired worker left his job. But those workers whose employers took steps to enable them to stay on the job were significantly less likely to leave that job following the onset of a health condition that limited their ability to work.

These data, not considered in the congressional debates, confirm that the employer's willingness to accommodate employees who suffer a work impairment is a crucial factor in their continued work. But the data also show that a substantial percentage of employers are already making such accommodations. Hence, the image of insensitive employers' irrationally refusing to accommodate their disabled employees that was conjured up by the anecdotal stories quoted in the Senate testimony grossly simplifies reality.

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What is still not clear, however, is what influences an employer to provide accommodation. While employers may not "irrationally" refuse to accommodate workers when the costs of doing so are lower than the benefits, it is very likely that these same firms do not accommodate the disabled when the costs exceed the benefits. Hence,

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D'Reilly
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it is possible that it is this "rational" discrimination that dominates in the marketplace.

If the goal of federal policy is to address this rational discrimination and thus to increase the chances that a typical disabled person will stay in the labor force, several alternatives present themselves. The ADA compels employers to accommodate disabled workers, even when the costs to them of doing so exceed the benefits the firm receives, as long as those costs are not an undue burden. This requirement will surely increase accommodation of the disabled to some degree. But there are alternative policies that would recognize that all the benefits of an accessible workplace are not captured by employers and employees. Many of us may believe that the disabled should be able to work even when the value of their output does not equal the cost necessary to accommodate them in the workforce. If this correctly represents our attitudes about the disabled, then this "positive externality" makes it entirely appropriate for all of us to bear part of the costs of accommodation through direct government payments. And on these grounds, the use of the income tax to fund these payments is likely to represent an improvement over the arbitrary cost incidence implied by the current ADA. The test of these propositions, however, is the willingness of voters to tax themselves to pay the real costs associated with accommodation. It is a sad commentary on the political process that a whole range of alternatives that would entail explicit federal budget outlays were completely ignored in the ADA debates. But it is not surprising, given the new criteria of good policy in Washington—doing good on the cheap.

Post-Gramm-Rudman Morality

The unwillingness of Congress to fund new social legislation from the budget has resulted in a renewed interest in mandates as a means of achieving social policy ends. Two major examples of this trend are the minimum wage increase and the strong push during the last presidential campaign for a national policy that would follow Massachusetts in mandating medical insurance for all workers. In the drive for such mandates, the Sirens' call of "no added costs to the federal budget" appears to have overpowered our nation's leaders.

The speed with which the ADA has moved through Congress is testimony to the power of the Sirens' song. When Sen. Orrin Hatch proposed an amendment last year that would have provided up to $5,000 in tax credits to small businesses to help offset the costs of accommodating the disabled protected by this bill, Sen. David Durenberger opposed him by asserting that "the constraints of the budget deficit make it very difficult, if not impossible, to find additional federal revenues to help offset these costs. . . . [W]e have absolutely no idea what the costs to the Federal government will be if we adopt this amendment" (*Congressional Record*, 1989). The almost total absence of information about the cost of the legislation to business or to the economy, however, did not prevent the ADA bill from being passed last year in the Senate, absent Sen. Hatch's amendment. The Sirens' song is most seductive.

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Will the ADA Increase Employment of the Disabled?

Historically, the federal government has relied on the private sector to provide jobs for the disabled and has been much less willing to intervene directly in the labor market either to create jobs for the disabled, as is done in Sweden, or to set em-

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ployment quotas for the disabled, as is done in West Germany. Hence, it is not clear from our past history how successful the ADA will be in increasing the labor force participation of the disabled. But a look at Sweden and Germany suggests that it is very difficult for the government to protect workers, let alone disabled workers, from the business cycle.

Because the federal government has relied on the private sector to provide jobs for the disabled and has been much less willing to intervene directly in the labor market either to create jobs or to set employment quotas for them, it is not clear how successful the ADA will be in increasing their labor force participation.

In Sweden the percentage of predisability income replaced by disability insurance exceeds the replacement rate in the United States, and Sweden's eligibility rules for disability benefits are much more liberal than ours. Thus, a Swedish worker without dependents who earned median wages over his lifetime would have 88 percent of his wages replaced. A worker earning twice the median would have 66 percent of his wages replaced. Furthermore, as Table 5 shows, the number of Swedish disability transfer recipients per thousand active workers far exceeds that in the United States. But what truly distinguishes Sweden from the United States or West Germany is its requirement that all disabled workers undergo rehabilitation and accept a job if one is offered and its willingness to guarantee a government job for any worker unable to find private sector employment. During Sweden's peak unemployment year, 1983, the government not only increased transfers, but dramatically increased the number of jobs offered to the disabled.

Disability benefits in West Germany also replace a greater proportion of predisability income than in the United States. A worker without dependents who earned the median wage before his disability receives a 67 percent replacement and a 65 percent replacement if he earned twice the median wage. West Germany is also strongly committed to ensuring that physical or mental impairments do not result in the loss of work for the disabled. But unlike in Sweden, the government does not provide directly subsidized employment. Instead, private employers are required to employ one disabled worker for every 16 able-bodied workers. In the past decade the number of transfer recipients per thousand active workers has also substantially exceeded that in the United States, and during its recession of the mid-1980s, substantially exceeded that in Sweden.

Slack demand puts intense pressure on firms to reduce their payrolls in West Germany. The eligibility of older disabled workers for special early-retirement benefits makes them likely targets. In 1985 only 5.0 percent of covered jobs were held by disabled workers, so that the quota was not met. Employment among the disabled fell both because overall employment fell and because firms chose to pay fines for noncompliance rather than to maintain disabled workers in their jobs.

In the United States, our public-sector commitment to the disabled is much less than that in

Table 5: Disability Populations in the United States, Sweden, and Germany

	Disability Transfer Recipients per Thousand Active Labor Force Participants				Supported Work per Hundred Disability Transfer Recipients			
Country	1975	1980	1983	1985	1975	1980	1983	1985
United States	42	41	39	41	12	24	5	5
(unemployment rates)					(8.3)	(7.0)	(9.5)	(7.1)
Sweden	78	79	73	74	19	26	38	28
(unemployment rates)					(1.6)	(2.0)	(3.5)	(2.8)
Germany	68	77	93	97	38	49	40	34
(unemployment rates)					(4.7)	(3.8)	(9.1)	(9.3)

Source: Compilation of tables in Burkhauser and Hirvonen (1989).

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Sweden or West Germany. We have smaller ratios of disability transfer recipients, not because our population is less affected by work impairments, but because our criteria for eligibility are far more restrictive than those in these European countries. The demise of CETA (the Comprehensive Employment and Training Act) in 1981 ended our experiment with direct job creation in the United States. During our peak recession years, both transfers per recipient and supported work for the disabled fell.

Sweden can ensure higher employment for its disabled than can West Germany or the United States because the Swedes are willing to accept the added costs of such employment. Work by Burkhauser and Hirvonen suggests that it is this distinction, rather than any advantage the Swedes demonstrate in rehabilitation, that explains their commitment to work for the disabled. But even the Swedes are not totally indifferent to costs, and during their 1980s recession, they relaxed their policy of guaranteeing a job to older disabled workers and encouraged them to accept transfer benefits. West Germany also has a greater commitment to providing work for the disabled than has the United States, but despite quotas, employment of the disabled fell in the 1980s. Even a much greater commitment to the importance of work for the disabled was not sufficient to ensure that work during economic downturns. It is unlikely that case-by-case enforcement of the ADA will fare much better as a protection against the reality of the business cycle.

Are There Alternatives to the ADA?

Congress recognized that discrimination against the disabled is qualitatively different from discrimination against blacks or women. Hence, unlike under Title VII of the Civil Rights Act, the costs of accommodation are legally relevant under the ADA. Unfortunately, no serious evaluation of the potential benefits and costs of accommodation under this act was performed. Accommodation in the workplace through the provision of readers for the blind, sign interpreters for the hearing-impaired, or physical changes for the wheelchair-bound are real costs that must be borne by somebody. But so are the more-difficult-to-measure costs of allowing more flexible schedules or even part-time work for those whose health conditions reduce their stamina or require more of their time and energy to perform personal maintenance. Equally difficult to measure are the costs of providing a less-stressful environment for those with mental illness or less-complex jobs for the mentally retarded. Nonetheless, it is these more subtle costs that are relevant to the silent majority of the disabled who are not blind, hearing-impaired, or wheelchair-bound. And it will be these subtle issues that will keep our judiciary busy over the next decade as it determines what the obligations the ADA creates actually mean.

Because this Congress was not willing to commit budget outlays or tax preferences to offset the costs of the increased commitment to the disabled promised in the ADA, alternative means of achieving the same end were summarily dismissed. In fact, Congress almost killed one incentive employers now have to accommodate the disabled. Currently, section 190 of the Tax Code provides a deduction of up to $35,000 a year for removing architectural and transportation barriers. This provision was extended for only 9 months by the Senate, and attempts to broaden its definition of accommodation to that required under the ADA were also rejected.

It is expensive to accommodate disabled workers. The ADA puts the initial burden of accommodation on employers and forces their compliance through the courts. But eventually most of us will bear this burden through higher prices and lower factor earnings. Broadening tax deductions or providing a tax credit to employers willing to hire or retain as well as retrain disabled workers would make this cost explicit, but it also would recognize that we all must pay to accommodate the disabled. Tax credits are a much less obtrusive way than mandates to encourage behavior in the marketplace, and they are likely to be

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more successful in achieving our goal of a more accessible workplace for the disabled.

Conclusion

The ADA is another federal exercise in morality on the cheap. The strongest argument its supporters can muster is that it will not increase the cost to the federal budget. But this type of cost-benefit analysis completely ignores the added costs to the economy that such legislation entails. It is perfectly reasonable to argue that disabled workers should be accommodated in the workplace. It is highly likely that such accommodation has and will continue to have a positive effect on the ability of the disabled to continue to work. But extending current tax deductions or providing tax credits for such accommodation would be much more likely to achieve this end and to do so without the arbitrary distribution of costs and the blunt stick of court-enforced compliance.

Postscript. President Bush signed the Americans with Disability Act on July 26.

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Lost in Space

U.S. International Satellite Communications Policy

Robert W. Hahn and Randall S. Kroszner

While domestic policy toward telecommunications has undergone fundamental change over the past decade, policy in the international arena has lagged behind, particularly toward space satellite telecommunications. Just as AT&T once had a virtual monopoly over domestic telephone service, an international government enterprise, INTELSAT, continues to hold such a position in international satellite communications.

The market for international satellite services affects a wide variety of communications media. These include standard telephone calls, FAX, electronic mail, video conferencing, television and radio broadcasts, and a broad range of data services—from the collection of inventory and sales information from dispersed outlets to dial-up databases. Because this market has not been subject to the rigors of competition, however, it has failed to achieve its potential.

The basic policy problem is to introduce greater competition while maintaining or enhancing the global telecommunications network. Critics of proposals to increase competition frequently argue that the integrity of the network would be eroded by multiple suppliers. Although concerns about the network are legitimate, it is by no means obvious that a single or dominant supplier is better able to service a network than are multiple suppliers. In airlines, for example, multiple suppliers have managed to serve a complex global network, and in domestic telecommunications multiple providers of telephone networks link users across the country.

The purpose of this article is to evaluate U.S. policy toward international satellite communications and to consider the effects of INTELSAT on this market. We shall argue that the current regulatory structure prevents competition by raising significant barriers to entry for private firms without providing offsetting benefits. The struggles of two small companies attempting to enter the market will illustrate many of the problems of the status quo. In contrast, the experience with competition in the domestic satellite communications market will demonstrate the feasibility and desirability of dismantling the regulatory barriers. After describing INTELSAT's operation and how it is able to keep out rivals, we shall outline changes in U.S. policy that can play a crucial role in promoting innovation and competition in this growing global market.

The economic analysis of the current structure of the international telecommunications industry will suggest why a change is needed. The political analysis will explain why the government has resisted change and how change can be promoted that will result in technological advances and lower prices to consumers without threatening

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the integrity or viability of the INTELSAT global network.

The Structure of INTELSAT

In the early 1960s, spurred by concern about the Soviet development of communications satellites for their INTERSPUTNIK system, the United States became the prime mover behind the creation of a global satellite network. The Satellite Communications Act of 1962 (Section 101a) declared that U.S. policy was to establish "in conjunction and in cooperation with other countries, as expeditiously as practicable, a commercial communications satellite system, as part of an improved global communications network." Two years later the International Telecommunications Satellite Organization, known as INTELSAT, was formed as a multilateral government venture.

From the modest beginning of a single satellite in 1965, INTELSAT has grown to a network of 14 satellites in geosynchronous orbit linking roughly 750 earth station antennas serving virtually all countries outside of the Eastern bloc. Today INTELSAT controls more than $1.5 billion in assets with annual revenues of roughly $500 million. Like many monopolies, INTELSAT has enjoyed a handsome return on its investments, averaging more than 14 percent per year over the past 15 years.

INTELSAT operates as a user-owned cooperative with a two-tiered governance structure. At the top level is the Assembly of Parties or Members, consisting of the 118 countries that are parties to the INTELSAT Articles of Agreement.

From the modest beginning of a single satellite in 1965, INTELSAT has grown to control more than $1.5 billion in assets with annual revenues of roughly $500 million and, like many monopolies, has enjoyed a high return on its investments.

Each country has one vote. While a vote of the Assembly of Parties is needed to ratify major decisions, this body generally follows the advice of the Board of Governors, consisting of the "signatories" to the Operating Agreement.

The signatories are designated by the member countries to be the owners of their share of INTELSAT. Share ownership, along with representation in this second tier, is proportional to usage of the system. Thus, those who use the system the most have the most influence on the general, day-to-day operation and administration of INTELSAT. The current U.S. share, for example, is roughly one-quarter, down from majority usage in the early stages of the venture. The United Kingdom, with 13 percent, is the only other country to have a share above 10 percent. The "signatory" owners are generally the public telephone and telegraph (PTT) monopolies from each of the member countries.

In the United States, however, the Communications Satellite Corporation (COMSAT), created by the 1962 Act as a regulated but privately held firm, owns the U.S. share. In return for its duties as U.S. representative in INTELSAT, COMSAT has the sole right of access to INTELSAT from the United States. Thus, AT&T, MCI, television and radio networks, and news organizations may not deal directly with INTELSAT, but must go through COMSAT if they wish to use its international satellite services.

The economic rationale for INTELSAT was that it would be more efficient to build a single satellite network connecting different countries than to have several competing satellite systems. Such a "natural monopoly" argument had been made for domestic long-distance telecommunications: it appeared to be less expensive to have everyone use the same telephone system because competing parallel lines would result in a wasteful duplication of facilities. Similar natural monopoly arguments have been used for a wide variety of transmission and transportation networks, including natural gas, electricity, railroads, and airlines, all of which have been subject to deregulatory programs in the United States and elsewhere.

The economics of satellite communications is such that there is a very large initial cost of building and launching satellites, but a relatively low cost of adding users once the network is in place. Combining this argument about economies of scale with those about unnecessary duplication of facilities led to the general belief that competition in satellite communications was neither feasible nor desirable.

The INTELSAT Articles of Agreement, however, recognized that separate systems might be valuable in the future and contains Article XIV(d), which details a process for coordinating and approving separate systems. Domestically, the 1962 act (Section 102d) did not "preclude the

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creation of additional communications satellite systems, if required to meet unique governmental needs or if otherwise required in the national interest." As we shall see below, however, the restrictions placed on separate satellite systems deemed to be required "in the national interest" have hampered entry, and the Article XIV(d) process has turned out to be an effective anticompetitive weapon. Before examining the details of these obstacles to competition, we must evaluate the economic merits of permitting competition in this industry.

Why the Monopoly Is Not "Natural" and Competition Would Now Be Beneficial

While the natural monopoly argument may have had some relevance in the 1960s, it no longer applies. The rationale for protecting INTELSAT from competition has been undermined, to a large extent, by INTELSAT's own success. Capacity on the INTELSAT network has mushroomed from an initial level of 150 circuits on its first satellite in 1965 to 5,000 in 1970 to over 100,000 circuits today on its 14-satellite network. Changes in technology and growth in demand have meant that several firms can compete successfully, which is one reason for the private sector's strong interest in entering international telecommunications markets. Indeed, a number of regional systems have grown up alongside INTELSAT: Eutelsat serves Europe; Arabsat serves the Arab nations; and Palapa provides services to Indonesia and surrounding countries. Because these systems are operated by INTELSAT member PTTs, however, they offer little in the way of direct competition.

Given the small size of the market in its early years and the cost structure of the technology, it may have been economically feasible to support only a single supplier of international communications satellite services. As technologies have developed to reduce the costs of such services, and as the information-processing revolution of the past two decades has dramatically increased the demand for rapid worldwide data transmission (for example, witness the growth of the financial services sector), the market is now sufficiently large to support multiple competitors without needless duplication.

The natural monopoly argument strictly applies only on a satellite by satellite basis. Once the market is large enough to demand more capacity than is available on a single satellite, there is no reason for the subsequent satellites to be owned by the same entity if the technology is compatible. Even if it were determined that the natural monopoly argument applies at the level of a global network, the earth can be covered with a set of three satellites in geosynchronous orbit. In addition, technology has advanced so that satellite transponders can be tailored to satisfy efficiently very specific needs of increasingly diverse users.

Without the discipline that competition generates, INTELSAT lacks adequate incentives to hold down costs.

Thus, two satellites, even if serving a similar part of the globe, could provide very different services so that there need be no "wasteful" duplication.

While these arguments undermine the case for natural monopoly at a somewhat abstract level, the most compelling argument on behalf of competition in international satellite communications is the fact that such competition works quite well in the domestic U.S. satellite communications market. In the early 1970s the Federal Communications Commission rejected an INTELSAT-type approach for the development of domestic satellite systems. Instead, the FCC has followed a policy of relatively open entry, which relies primarily on the forces of the market rather than regulation. More than a half dozen systems have appeared. The competition has resulted in high-quality service at low costs. Charges for private-line business service between New York and Los Angeles, for example, can be less than a third of those for comparable international service between New York and London. A great variety of specially tailored business services have been available for a long time in the United States. They are only beginning to appear in the international market.

Without the discipline that competition generates, INTELSAT (as well as COMSAT) lacks adequate incentives to hold down costs. This problem, which results from having a protected position in the market, is not unique to INTELSAT. Before competition in the domestic long-distance market, AT&T also lacked this incentive. Since the deregulation of AT&T in January 1984, long-distance rates have dropped by more than one-third after adjusting for inflation. While part of

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this drop is due to the phasing out of the subsidy from long-distance to local service, part resulted from cost-cutting measures aimed at making the company more productive and competitive. Sizeable reductions in prices could also be expected in the international satellite market if competition were introduced. Moreover, there is strong reason to believe that the range of services would be expanded, as happened after MCI and others entered into competition with AT&T. In the areas where some competition with INTELSAT has been permitted, such as video and a limited range of business services, INTELSAT has developed new offerings to meet the challenge.

The Policy Context

Recognizing the potential for private development of satellite systems, the White House issued a presidential determination on November 28, 1984, stating that "separate international communications satellite systems are required in the national interest." This decision, which appeared to encourage new entrants, was precipitated by applications to the FCC containing proposals from a number of private firms to offer international satellite services in competition with INTELSAT and COMSAT. The explicit support for separate systems was an important boost for private developers and paved the way for entrepreneurs to try to enter the market. Compromises in implementing this directive, however, have imposed conditions on the operations of potential rivals that have significantly curtailed the benefits for both private satellite owners and users.

The main problem arose in defining how separate satellite systems would be linked to existing domestic networks—specifically, the "public switched network," which is essentially the entire telephone and telegraph network. The policy was defined by the so-called "separate systems restrictions," a compromise that has satisfied no one: many INTELSAT members protested even though the policy severely circumscribes any potential competitive benefits. The separate systems restrictions prohibit private systems from providing their customers with services that in some way may access the public switched network. This restriction was designed to shield INTELSAT from any competition in its "core" long-distance telephone traffic.

This restriction, however, has far more serious consequences than preventing alternative systems from carrying regular telephone calls. It prohibits private entrepreneurs from offering a large variety of international voice and data services, including specialized business services, because most such traffic either directly uses or indirectly spills into the public switched network. For example, an international internal corporate communications service could not be offered by a private satellite company if employees could use the same phones for calls to other businesses. The restriction affects virtually all industries using data base management systems that need to be linked across countries. These include such varied users as financial services firms, the Defense Department, and discount store chains.

Separate systems restrictions prohibit private entrepreneurs from offering a large variety of international voice and data services because most such traffic either directly uses or indirectly spills into the public switched network.

The restrictions on separate systems are inconsistent with a previous transborder policy that allowed domestic private satellites to provide a full range of international services to "nearby" countries in addition to their primarily domestic services. This meant that satellites that were providing domestic services in the United States could link to the public switched networks in the United States and nearby countries, such as Mexico, but a satellite company wishing to offer primarily U.S.–Mexico service was precluded from doing so. In contrast, no similar access restrictions govern private international cable or fiber optics operators. The separate systems policy thus is biased against the development of full international satellite services.

A Self-Regulating Monopolist: How INTELSAT Stifles Competition

While the separate systems restrictions hinder the ability of rivals to offer a full range of services, INTELSAT has exercised its powers to erect effective barriers to competition. A key weapon in INTELSAT's anticompetitive arsenal can be found in Article XIV(d) of its charter, which requires would-be competitors to coordinate and gain ap-

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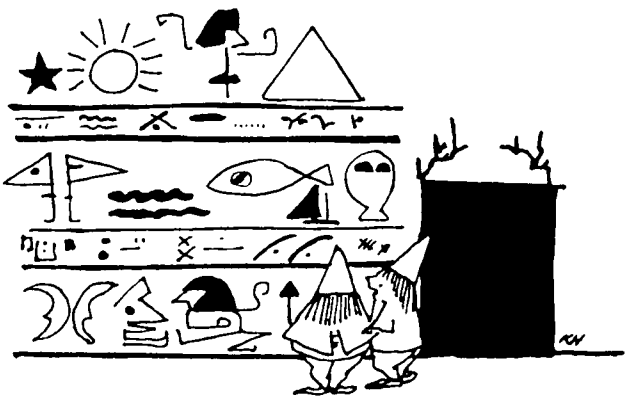
proval for their activities from the monopoly itself! Specifically, the article obligates INTELSAT members to have any potential international commercial satellite operator consult with INTELSAT concerning its planned activities. The competing operator must also gain an approving vote of the members before it can provide service.

Thus, INTELSAT not only provides services, but also regulates its competitors and potential competitors. Other satellite operators must share their business plans with INTELSAT before they begin operations and thereby give INTELSAT critical information about their potential competition and an opportunity to respond and preempt the competition. In addition, the lengthy consultation process permits INTELSAT to delay entry, a claim that the Pan American Satellite Corporation (PanAmSat) has made in a recently filed antitrust suit against COMSAT and, implicitly, INTELSAT. PanAmSat, which gained Article XIV(d) approval and launched a satellite in 1988, four years after its initial application to the FCC, is the first and only private U.S. satellite operator in direct competition with INTELSAT.

A key weapon in INTELSAT's anticompetitive arsenal is its charter's requirement that would-be competitors coordinate and gain approval for their activities from the monopoly itself!

This coordination and approval process gives INTELSAT crucial control over entry by competitors. Besides requiring competitors to meet some technical compatibility and noninterference criteria, the INTELSAT charter requires that approval be based on a determination that the separate satellite system does not cause "significant economic harm" to INTELSAT. The calculation of economic harm is not specified. INTELSAT has used this ambiguity to its advantage by allowing the introduction of limited satellite systems that are owned and operated by the member PTTs, while impeding the entry of private systems that could pose a competitive threat. For private satellite systems, INTELSAT calculates roughly that every circuit planned on the separate system will result in one less circuit used on INTELSAT, even if the types of services proposed are different from those currently offered by INTELSAT or are offered in areas not well served by the INTELSAT network. Regional systems owned and operated by the PTTs—including Eutelsat, Arabsat, and Palapa—have been given easy approval, with a calculation of negligible economic harm. In contrast, private systems, such as PanAmSat and Orion Satellite Corporation, are subject to long and arduous approval processes with "economic harm" calculated as the maximum possible traffic diversion.



"Probably regulations regulating deregulation."

Such calculations of economic harm, even if they were not applied in a discriminatory way, are without economic merit. INTELSAT's calculations of harm assume that the quantity of telecommunications services demanded is chiseled in stone and is unaffected by new services or changes in prices. This assumption is not justified, particularly when services offered on the separate system would be outside INTELSAT's core telephone traffic, which uses relatively low-power satellites. Indeed, one user survey points out that separate systems would provide many specialized business services (for example, through the use of high-power satellites requiring only small and inexpensive ground antennas) that would tend to increase, not decrease, the demand for complementary international telephone traffic. In short, the whole exercise of computing economic harm is based on the misguided presumption that competition is harmful.

In addition to discriminating among entrants on noneconomic grounds, members of INTELSAT have discussed precluding all entry after a certain level of economic harm has been reached. INTELSAT measures and adds up the "harm" of each new entrant. The current level of total harm is nearing 10 percent, and capping the maximum level of harm in this general range appears to be

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favored by many. After that, no more satellite systems would be approved. There is no charter requirement for this or any other level to trigger the close of entry, but it has been arbitrarily chosen to signal INTELSAT's attitude toward rivals.

INTELSAT has just taken the first step toward implementing this policy. In July 1989 the Board of Governors and Assembly of Parties took what has been characterized as the "unprecedented" step of finding that Orion Satellite Corporation's proposal to provide transatlantic service would result in significant economic harm to INTELSAT. While Orion did not receive a "favorable" finding in its consultation, INTELSAT will permit Orion to go forward in light of assurances by the United States and the United Kingdom that Orion's activities will be quite limited and not permitted to grow beyond the specific services already requested. These assurances, of course, hobble Orion's ability to act as a full-fledged competitor since its activities are already narrowly circumscribed. This treatment of Orion suggests that future potential competitors will be met with increasing hostility.

INTELSAT has also demonstrated its position toward potential competition through another device used by monopolists to deter entry—the boycott. In 1984, as potential rivals such as Orion and PanAmSat were making their initial applications to the FCC, the members of INTELSAT adopted a resolution explicitly calling for the members "to refrain from entering into any arrangements which may lead to the establishment and subsequent use of" separate systems not owned or operated by the PTTs.

The so-called uniform pricing policy, which is claimed to provide a subsidy to the low-density users primarily among the developing nations, has combined with capacity decisions to support anticompetitive pricing without benefit to the Third World.

Although INTELSAT has been able to thwart competition from private satellite systems, earth-based fiber-optic cables could impose some competitive discipline for some types of service. Fiber-optic cables are well suited to serving point-to-point links where traffic flow is intense, and innovations in fiber-optic technology have made it more competitive with communications satellites over increasing distances. Satellites continue to have an advantage in serving dispersed (or mobile) multipoint connections with low and medium usage. The rapid growth in undersea fiber-optic cable capacity that has occurred in the 1980s and is forecast to continue appears to place the greatest pressure on INTELSAT's core long-distance telephone market. Virtually all of the international optic lines, however, are wholly or partially owned by the PTTs, which are the shareholders of INTELSAT. Thus, the scope for vigorous economic competition between the two modes is much narrower than the technical comparison may make it appear.

The Impact of INTELSAT's Capacity and Pricing Policies

In addition to INTELSAT's ability to determine against whom it will compete, it has engaged in two further practices designed to thwart competition: building excess capacity and predatory pricing. The so-called "uniform" pricing policy, which is claimed to provide a subsidy to the low-density users primarily among the developing nations, has combined with capacity decisions to support anticompetitive pricing without benefit to the Third World.

INTELSAT's charter mandates that it charge uniform prices for similar services. This implies that all users should be charged the average cost of providing a service and not the cost imposed by the particular user. By charging one group an excessively high price and another group an inappropriately low price, INTELSAT distorts users' choices and wastes resources. A similar problem existed in domestic telecommunications, whereby long-distance users have subsidized local users, with resulting inefficiencies.

To understand how its uniform pricing policy has been used to thwart competition rather than to subsidize the less-developed nations, we must understand INTELSAT's average costs and how they are related to capacity decisions. Not only does INTELSAT charge prices that are not related to costs users impose on the system, but also there is reason to believe that INTELSAT's average costs are excessive because its system is significantly overbuilt. INTELSAT claims that approximately two-thirds of its capacity is in use, but a recent study by the Organization for Economic

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Cooperation and Development estimates that only half of INTELSAT's current capacity is used. In addition, the excess capacity is projected to grow with the new generation of satellites INTELSAT is planning to launch over the next five years.

Not only does INTELSAT charge prices that are not related to costs imposed on the system, but there is reason to believe that INTELSAT's average costs are excessive because its system is significantly overbuilt.

INTELSAT's deployment of additional satellites has been based on wildly optimistic projections of traffic growth. This overbuilding is in part due to larger users' overestimating future demands and including a "safety margin" for future traffic growth. Because the uniform pricing policy spreads the costs of these overestimates to all users, countries do not have the appropriate incentives to develop reasonable estimates of capacity needs. This "free-riding" induces a bias toward excess capacity. Users of low-density routes thus have to pay higher average costs stemming primarily from the choices of high-density users. This excess capacity also results in an inefficient allocation of scarce orbital slots that wastes valuable slots on satellites that are underused.

The manufacturers and launchers of satellite technology, the majority of whom are located in developed nations, pressure their governments to support very high estimates to increase the demand for their products. INTELSAT and the PTTs are predisposed toward accepting overestimates since excess capacity helps deter entry by potential rivals. Would-be competitors are keenly aware that excess capacity enables a protected monopolist, such as INTELSAT, to undercut its competitors' prices. New classes of service can be introduced at little or no additional cost, given the tremendous excess capacity. Applying some creative accounting principles along with an ability to define new classes of service allows INTELSAT to stick to its "uniform" and "incremental cost-based" pricing rules while actually pricing in a predatory manner.

INTELSAT responded to competition in nonswitched traffic (for example, certain specialized business services and video) by creating new classes of video and business services at uniform low prices. In the Caribbean and South America, where PanAmSat has entered negotiations to provide service, INTELSAT has created new classes of service in nonswitched traffic and has begun new ventures at prices far below those previously available on INTELSAT. The organization has tried to suggest that these prices are cost-based, but this defense conveniently ignores the costs of building and launching satellites. Since INTELSAT's monopoly is protected in its core telephone traffic, INTELSAT generates the revenues to cover the excess capacity from higher prices in its protected lines of business.

One defense of INTELSAT's immunity from competition is the claim that its pricing policy subsidizes Third World countries' telecommunications services. The costs of INTELSAT's chosen satellite technology, however, are such that per circuit high-density use is more efficient than low-density use. The dense routes between the major industrialized countries supposedly subsidize the less heavily trafficked Third World routes. But a number of studies, including one commissioned by INTELSAT, could not identify such a subsidy to the Third World.

Even if there were a cross subsidy in satellite circuits, developing countries still may not gain from the INTELSAT system, because INTELSAT relies on low-power satellites that require large and expensive earth stations. While this technological choice is well suited for high-density, point-to-point traffic, the large initial investment required for the construction of a large earth station results in a very high ground segment cost per circuit for low-density routes. The investment cost per circuit for a large earth station is twice as great for developing nations as for the developed ones. Moreover, if a country opts for a small earth station (which involves some loss in signal quality), INTELSAT imposes a heavy surcharge, ranging from 50 percent to 250 percent of the circuit rate charged to large earth-station users. This charge system favors large earth-station users in developed countries.

Further evidence against the view that the Third World nations are receiving subsidies is the fact that PanAmSat has agreements with nine Latin American countries. PanAmSat has been most actively engaged in negotiations with countries in South America and the Caribbean, not the major developed nations. Thus, a private system can offer more attractive services even where INTELSAT is supposedly subsidizing customers.

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A Strategy for Introducing Competition

The United States has a simple policy lever that it can use to facilitate greater competition in international satellite communications networks. It can alter the separate satellite systems policy to permit access to the public switched network. This can be done through an executive order and an FCC rulemaking, without an act of Congress or approval from INTELSAT members. This change would unleash competitive forces that would put pressure on monopoly PTTs and their governments to liberalize telecommunications policy so that users could take advantage of the lower prices and new services. INTELSAT could no longer count on its protected core telephone traffic revenues to finance predatory pricing in other areas.

The United States can facilitate greater competition in international satellite communications networks by permitting access to the public switched network. The next step in the evolution of an efficient market structure is the privatization of INTELSAT, which will be a much more complex task than introducing competition into the market because the United States has no simple unilateral mechanism available to effect such a change.

The proposal to introduce competition with INTELSAT follows the outline of domestic U.S. telecommunications deregulation on an international scale. In the U.S. domestic market, the same company had owned and operated the long-distance and local phone service providers. In the international market, the PTT in each country controls domestic communications as well as owns and operates the long-distance international links jointly through INTELSAT. The new private satellite (and fiber optics) entrants would play much the same role as new entrants in the domestic telecommunications market—introducing new services, cutting prices, and forcing the incumbent monopolist to follow suit.

COMSAT's role should also be reexamined. COMSAT is faced with a conflict of interest as both the U.S. representative to INTELSAT and the owner of the U.S. share of INTELSAT. What is good for INTELSAT is not necessarily beneficial to either U.S. customers or customers around the globe. COMSAT possesses the monopoly right of access to INTELSAT from the United States. COMSAT should be relieved of its gatekeeper function as soon as possible. Companies should be allowed to negotiate directly with all suppliers of international satellite services, including INTELSAT.

Despite the challenge to INTELSAT's privileged position, it is most likely that INTELSAT would survive, and possibly even flourish, with the introduction of greater competition. INTELSAT, just as AT&T, would enjoy the advantages of universal connectivity and extensive experience, so its market share is unlikely to erode quickly. Even with a reduced market share, however, the growth of the overall size of the international telecommunications market could more than compensate for the market share loss and could result in net benefits for INTELSAT, just as in AT&T's case. Thus, competition is perfectly consistent with the treaty obligations to INTELSAT.

The next step in the evolution of an efficient market structure is the privatization of INTELSAT. This is a much more complex task than introducing competition into the international satellite communications market because the United States has no simple unilateral mechanism available to effect such a change. Ridding entrants and potential entrants of the fear of anticompetitive retaliation from a government body would encourage both entry and innovation in the international telecommunications market.

The INTELSAT Assembly of Parties could play a key role in privatizing INTELSAT by ruling on rate reductions during the transition and serving as a forum for public debate. After removing any pricing restrictions and entry barriers, there would be no need for further intervention. The same standards for operation and noninterference that have been agreed to by international treaties and assemblies would still govern, just as they do for domestic satellites. Thus, international telecommunications would be subject to the same forces that shape long-distance communications in the United States—the discipline of competition rather than excessive government interference.

Undoubtedly, there would be resistance to these proposals from a wide range of groups including the PTTs, satellite manufacturers, Third World nations, and the U.S. defense establishment. We shall consider each party's interest in

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turn and suggest how the introduction of competition is likely to affect these groups.

The PTTs are understandably concerned that opening up international communications markets would reduce their ability to set prices above competitive levels on international services. Indeed, some bypass of the PTTs is likely. Again, the problem is quite similar to the issues with bypass in the domestic telecommunications market. As large businesses opt out of the system, local phone companies place pressure on the public utility commissions to raise rates to those customers that remain to maintain profits and cover fixed costs. Such rate increases can lead to situations where firms elect to bypass the current system because they are receiving the wrong price signals (so-called "uneconomic bypass"); however, this may be a price well worth paying in the short run for eliminating an inefficient monopoly in the long run. It is precisely these types of pressures that led to growing support for telecommunications deregulation in the United States.

Another group that might oppose these proposals is the major manufacturers of telecommunications satellites and associated products and services (for example, booster rockets and launches). These manufacturers have developed a close relationship with INTELSAT, and they are well aware of INTELSAT's tendency to invest in excess capacity. Opposition from this group, however, may be far from unanimous. Some manufacturers would realize that lower prices and greater competition could improve the market for satellites, launches, and related services. The lure of producing and launching satellites for private firms would certainly lead to dissension within the industry and would undermine its ability to lobby with a uniform voice.

Many developing countries appear to object to altering INTELSAT. This objection, however, is not universal since a number of such countries have made agreements with PanAmSat. Many of these countries are well aware that potential competition can result in lower prices and improved services from INTELSAT and its rivals. Greater competition is likely to help, not hinder, the development process. While some developing nations may enjoy the prestige of participating on a one-country–one-vote basis in the Assembly of Parties, economic considerations are likely to prevail.

A final group that raises objections to competition is the U.S. defense establishment. National security procedures could be complicated by multiple communications networks, but the advent of fiber-optic cables presents at least as many complications. Similar objections were raised regarding the breakup of AT&T, but it does not appear that security has been compromised as a result.

Many developing countries appear to object to altering INTELSAT, although some are aware that potential competition can result in lower prices and improved services.

Indeed, having multiple systems increases the number of backups (so-called redundancy) available. The shoe is now on the other foot as AT&T attempts to gain permission from the FCC to connect with INTERSPUTNIK. AT&T notes that in addition to improving East-West relations, "use of INTERSPUTNIK will increase route diversity resulting in greater network reliability and resiliency." In short, separate competitive systems could result in a net enhancement of overall security, particularly in light of the changes that are taking place in Eastern Europe and the U.S.S.R. In addition, because the military is a large user of international commercial satellite services, competition is likely to bring down the costs of its operations.

In summary, some of the groups likely to oppose these changes may be better off in a competitive environment, but this is probably not true for the monopoly PTTs. For these reforms to take hold, a constituency needs to be developed to counter the objections of entrenched special interests. If the United States lifted its restriction on access to the public switched network, this constituency would emerge through the pressures of businesses wishing to bypass the PTTs.

While lower prices and a wider range of services can be predicted with a high degree of confidence, precise quantitative projections are difficult to develop. On the basis of the current volume of U.S. usage—which would undoubtedly increase as prices fell—we estimate that U.S. customers alone would save on the order of $150 million annually from lower charges for existing international satellite services. This estimate does not include any of the potentially enormous benefits that would accrue from either new services or worldwide deregulation of telecommunications

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services. For example, a study of the international telecommunications market reveals that international callers are overcharged by $10 billion annually. Thus, introducing greater competition in this market alone could lead to substantial efficiencies.

Conclusions

U.S. policy in international telecommunications has helped sustain a monopoly that has outlived whatever usefulness it may have had. We have outlined the options for moving to a more competitive environment that would result in a wider menu of services in international communications and lower prices.

The United States can be a pioneer in moving toward a more competitive and efficient industry structure in international telecommunications. The first logical step is to lift the restriction denying private entrants access to the public switched network. Whether this would be sufficient to break the monopoly remains to be seen. There are very strong interests in place, both here and abroad, that benefit from the monopoly. As we have tried to point out, however, the costs of keeping these special interests happy are quite high. What is needed is an opposing force that will push for reforms that are long overdue. The proposals suggested here would help unleash that force, and in so doing, would provide greater impetus for high-technology innovation.

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Automobile Insurance Regulation, Direct Democracy, and the Interests of Consumers

Benjamin Zycher

Bring the kids indoors. Hide the silverware. And, above all, hold on to your wallet. Why? Because the consumer groups—unelected, unappointed, and unaccountable—have taken it upon themselves to protect us from the purportedly dishonorable intentions of the insurance industry. This most recent of the consumerist crusades has manifested itself in that old trendsetter, California, where, amid the tolling of church bells and the joyous shouts of aspiring bureaucrats, the voters in November 1988 approved Proposition 103, a system of price and regulatory controls on property and casualty insurance.

This law was the response of the electorate to the unwillingness of the state legislature to deal effectively with a perceived "crisis" caused by escalating automobile insurance rates. It was also the response to the prospect of a blatant wealth redistribution scheme. Before turning to the provisions and implications of Proposition 103 itself, it is useful to review briefly the sources of the perceived crisis in the California market for auto insurance, as well as the straightforward politics of Proposition 103. I then explore the economic and regulatory implications of Proposition 103 and derive some conclusions, which ought to be of interest to those in other states faced with similar regulatory proposals and political pressures.

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The "Crisis" in the California Market for Auto Insurance

When consumer groups proclaim the presence of a crisis, what they usually mean is a pattern of rising (real) prices for some particular good, particularly as the price increases may affect the consumerists' political constituencies adversely. (Indeed, consumer groups often are able to find signs of impending crisis regardless of the pattern of price movements.) Since some prices in a market economy are certain to rise, absolutely or relative to others, no economy in which prices are

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driven by market forces can be free from "crises" afflicting helpless consumers. By that criterion, "crisis" is too mild a term to describe the recent throes of the market for auto insurance in California. Between 1982 and 1986, average auto insurance premiums rose 10.2 percent annually for the nation as a whole, while in California they rose by 12.2 percent. During 1987 and 1988, premiums in California rose at an annual rate of over 14 percent, and by 1988 the average premium per insured vehicle in California ranked fourth in the nation—exceeded only by Massachusetts, New Jersey, and Nevada. In 1988 the average premium per insured auto in California was $673.18, while for the rest of the nation, the figure was $482.47, a difference of almost 40 percent.

Rapidly rising insurance premiums in California were the natural market response to large increases in important costs faced by insurance companies that were greatly exacerbated by misguided regulatory policy. The average size of insurance claims rose substantially during the 1980s. Cost increases in medical care, auto repair, and litigation have all contributed, but the cost surge has been greatest in liability coverage, that is, in compensation for bodily injury and property damage. From 1982 through 1988 the number of insured autos increased about 3.5 percent per year, but the number of paid claims rose by over 18 percent per year, and the average cost per paid claim rose by almost 15 percent annually.

The number of bodily injury claims per insured auto rose by about 2 percent per year between 1982 and 1985, but then increased sharply over the next three years. They rose by almost 7.5 percent in 1986 and by over 9 percent in 1987 and again in 1988. Moreover, the average size of such claims rose by about 10.5 percent annually between 1982 and 1988. Meanwhile the consumer price index for medical care rose just over 7 percent per year over the same period. As a result, the average bodily injury claim paid in California in 1987 was $6,505; for the other 26 states with a tort (fault) system of auto insurance, the average during 1987 was $4,519, a difference of 44 percent.

In addition, auto litigation costs increased annually in California by over 13 percent between 1982 and 1988. Increased litigation tends to increase total costs because of attorneys' fees, court fees, the costs of obtaining depositions, and other expenses. Moreover, the prospect of litigation provides incentives to inflate medical bills as awards for pain and suffering are often computed as a proportion of direct medical expenses. The number of property damage claims per insured vehicle fell by over 1 percent each year between 1982 and 1988, but the average size of these claims increased by about 9 percent per year. For collision and comprehensive insurance coverage, the number of total claims paid increased by almost 9.5 percent per year and rose by almost 6 percent annually per insured vehicle. This increase in insurance company outlays came about despite both an annual decline of roughly 2.4 percent in the number of collision claims per insured auto and a yearly reduction of over 4 percent in per-vehicle comprehensive claims. Sharply higher repair costs drove the average size of collision and comprehensive claims up by about 8 percent annually.

Rapidly rising insurance premiums in California were the natural market response to large increases in important costs faced by insurance companies that were greatly exacerbated by misguided regulatory policies.

Misguided Regulatory Policy: The Assigned Risk Program. The effects on insurance premiums of the cost escalation just described have been greatly exacerbated by recent regulatory decisions with respect to pricing in the California Automobile Assigned Risk Plan (CAARP). All insurance companies writing auto insurance in the state are required to participate in the assigned risk plan in proportion to their share of the state auto insurance market. CAARP was established to provide insurance to high-risk drivers unable to purchase it in the voluntary market. CAARP rules require that a driver be rejected by two companies in the voluntary market before he is eligible for an assigned risk policy. This constraint on eligibility is widely ignored, however, in large part because CAARP rates must be approved by the insurance commissioner, and approved rate increases during the 1980s have lagged far below those necessary to cover the costs borne by the assigned risk program.

From the viewpoint of consumers, therefore, assigned risk policies have become a very good deal indeed. For example, a typical premium in

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1988 for an adult male who lived in Watts and had no citations or at-fault accidents was $1,640. The premium for a similar policy available under the assigned risk program was $575. For a large number of drivers in California, CAARP has come to represent an insurer of first choice rather than last resort. Indeed, many insurance agents steer their clients into the assigned risk program as a means of acquiring "cheap" insurance. As Table 1 shows, new applications for auto insurance policies under CAARP have grown by an order of magnitude over the past several years.

Table 2 shows the relationship between revenues and costs in the assigned risk program. In the first six months of 1989, for example, CAARP's total costs exceeded premiums by almost two to one. In 1983 the CAARP deficit was $30 million. It grew to $40 million in 1984, $78 million in 1985, $152 million in 1986, $262 million in 1987, and $400 million in 1988, and the data for the first six months of 1989 indicate that the loss for all of 1989 probably exceeded $600 million. These deficits represent actual costs faced by the insurers, and so they must be paid by someone. Not surprisingly, the policyholders in the voluntary market must make up the difference by paying higher premiums.

This becomes apparent when we examine the experience of a single insurance company. As an example, assigned risk policies constitute only 6.4 percent of total California policies in force for the Farmers Insurance Group, but these policies account for over 46 percent of Farmers' auto insurance underwriting losses in California. These losses caused Farmers to announce a statewide rate increase averaging 5.9 percent in late 1989. Since 1984, the number of Farmers' voluntary market policies has grown by about 16 percent, while the number of its assigned risk policies has grown by almost 770 percent. During the same period, underwriting losses in the voluntary market grew by about 40 percent, while similar losses in the assigned risk market grew by well over 2,400 percent. The result is a daily loss on assigned risk policies for Farmers of over $250,000, and a loss for all of 1989 exceeding $100 million.

Table 1: New Applications for Assigned Risk Insurance Policies in California (thousands)

Year	Number	Percent Change
1983	94.4	
1984	136.7	44.8
1985	329.3	140.9
1986	323.8	(1.7)
1987	425.7	31.5
1988	781.2	83.5
1989	1233.4	57.9

Source: Western Association of Automobile Insurance Plans.

Table 2: Revenues and Costs of the California Automobile Assigned Risk Plan

Year	Premiums (millions of dollars)	Direct Losses (millions of dollars)	Loss Ratios (partial[a])	Loss Ratios (total[b])
1984	63.7	64.4	1.011	1.412
1985	111.5	111.1	0.997	1.393
1986	181.2	220.7	1.218	1.639
1987	220.0	322.8	1.467	1.939
1988	376.4	513.2	1.364	1.832
1989[c]	243.2[c]	367.0[c]	1.509[c]	1.998[c]

Source: LeBoeuf, Lamb, Leiby, & MacRae.

Note: Data are for eleven companies writing about 77 percent of private automobile insurance in California.

[a] Direct losses/premiums.

[b] After inclusion of loss adjustment and administrative expenses, taxes, and various fees.

[c] Six months ending June 30, 1989.

From the viewpoint of consumers, assigned risk policies have come to be a very good deal. A typical premium for an adult male who lived in Watts and had no citations or at-fault accidents was $1,640 while the assigned risk premium for a similar policy was $575.

By law, CAARP must request rate adjustments each year that yield no profit in an accounting sense but that are adequate to pay claims and expenses. The authority to approve or deny these requests in whole or in part in straightforward regulatory fashion rests with the state insurance commissioner. Table 3 shows the requests and authorizations since 1983.

Obviously, disagreement can exist about the allocation of costs to the assigned risk program as well as about other accounting issues. The requested rate increases may be inflated in the expectation that the insurance commissioner will deny them in part. Nonetheless, there is little question that the assigned risk program fails by a substantial margin to cover its costs. Rate regulation in California has clearly created a large sub-

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Table 3: Requests and Approvals for Assigned Risk Policy Rate Increases

Request Date	Percent Requested	Percent Authorized	Effective Date
April 1983	33.7	8.4	March 1984
July 1984	15.0 + 15.0[a]	13.9	January 1985
May 1985	62.0	10.7	February 1987
December 1986	25.0 + 25.0[a]	18.5	December 1987
February 1989	112.3	denied	litigation pending

Source: LeBoeuf, Lamb, Leiby, & MacRae.
[a] Single request for two increases over a six-month period.

sidy flowing from drivers participating in the voluntary market to those holding CAARP policies, a relationship that has prevailed since the early 1980s. Moreover, a 1987 law requiring California motorists to carry liability coverage has brought into the system a large number of drivers who have disproportionately acquired the necessary coverage through the assigned risk program. In short, along with the generally rising costs of settling claims, the expanding subsidy embodied in CAARP has exacerbated the perceived crisis in the California auto insurance market.

A common argument deems it appropriate to hold down rates in the assigned risk market to increase the availability of auto insurance to lower-income drivers. It is not at all clear, however, that the cross subsidies inherent in CAARP's pricing policies are an effective tool with which to subsidize lower-income individuals. Moreover, while some drivers in the assigned risk pool are newly registered in California and may therefore find it difficult to provide information about their past driving records, most drivers participating in the assigned risk system have poor driving records. Why should individuals representing an above-average risk receive a subsidy from better drivers? More to the point, there are often alternative modes of transportation by which an individual with a bad driving record can meet his transportation needs. Drivers who cannot afford to pay the costs they are likely to impose on others should be encouraged to take the bus, for example. Bus transportation is neither very fashionable nor enjoyable, and it is often inconvenient, but it is not life-threatening, and many people use it daily.

Geographic Variation in Costs and Rates

The large increases in average California auto insurance premiums obscure great variation in average premiums among different geographic areas within the state. For example, in 1988 an adult male with no citations or at-fault accidents who lived in Hollywood typically paid an annual insurance premium of $1,817. If the same driver lived in nearby Monrovia, his annual premium would have been $862, in San Diego $697, in San Jose $581, and in Redding $537. This variability exists because the insurance market is driven by competitive pressures to charge individual drivers premiums that compensate the insurance system for the cost of providing a particular policy, including administrative expenses and the losses that an individual driver is expected to impose. If insurance companies did not charge premiums that reflected the expected costs of insuring a given driver, low-cost consumers—such as good drivers—would necessarily subsidize high-cost ones, and competitors would seek to attract new customers by offering the low-cost drivers a better deal. In a market without significant price regulation, price structures that include cross subsidies are not viable for long.

A common argument deems it appropriate to hold down rates in the assigned risk market to increase the availability of auto insurance to lower-income drivers, but it is not clear that these cross subsidies are an effective tool to subsidize lower-income individuals.

Thus, insurers determine premiums by considering an individual's driving record, age, sex, type of car, and other factors that are statistically significant predictors of an individual driver's future loss experience. As it turns out, place of residence is an important predictor of future losses. Drivers in rural areas tend to impose fewer costs upon the system than those in urban areas, as a result of lower vehicle densities, less theft, lower repair costs, and a host of other reasons. One way to compare the costs and premiums of rating territories in California is through data collected at the county level, presented in Table 4 for 20 counties.

Note that areas within counties can be far from homogeneous. Table 5 provides data similar to

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those in Table 4 for six cities within Los Angeles County.

Tables 4 and 5 show the strong correlation between geographic variation in expected costs, as measured by the frequency and average cost of claims, and geographic variation in premiums.

The large increases in average California auto insurance premiums obscure the great variation in average premiums among different geographical areas in the state.

(The correlation is not perfect because of differences in driving records, average age of drivers, and other relevant factors that do not appear in these data.) As it turns out, the wide variation in premiums across the state played an important role in the passage of Proposition 103.

The Politics and Provisions of Proposition 103

Sharply rising auto insurance premiums during the 1980s, particularly in the heavily populated counties, led to political pressure for insurance reform. The state legislature found itself paralyzed by the conflicting demands and goals of competing interests. The insurers were anxious to end or reduce the subsidies inherent in the assigned risk program and to limit lawsuits and resulting litigation costs. The trial lawyers opposed no-fault insurance plans and other proposals to limit litigation. The consumer groups acted to enhance their own political power by constraining the ability of market forces to operate. The legislators were interested in any solution that would redirect the political heat toward the insurance commissioner or the governor.

Because of the political gridlock, the competing interest groups introduced several ballot initiatives purporting to solve the insurance crisis. Proposition 100, promoted by the trial attorneys, would have mandated rate reductions similar to those of Proposition 103 and would have stipu-

Table 4: Bodily Injury and Property Damage: Average Claims, Costs, and Premiums for 20 California Counties in 1988

	Bodily Injury			Property Damage		
County	Claims[a]	Cost[b]	Premium[c]	Claims[a]	Cost[b]	Premium[c]
Los Angeles	23.9	$10,197	$319.04	46.8	$1,484	$113.45
Orange	19.5	9,270	255.00	45.9	1,423	100.01
Ventura	16.7	9,665	225.51	41.7	1,425	90.62
San Francisco	16.3	8,705	208.95	49.4	1,355	94.64
Riverside	15.2	8,888	200.16	39.3	1,411	81.77
San Bernadino	15.6	8,631	196.22	40.6	1,372	80.95
San Diego	16.0	8,330	191.80	45.0	1,222	80.66
Alameda	14.4	8,654	191.46	45.3	1,307	87.81
Marin	13.0	8,516	190.78	45.3	1,301	87.20
San Mateo	14.1	7,738	189.01	44.4	1,342	88.97
Sacramento	15.3	7,881	181.42	45.7	1,217	83.09
Santa Clara	14.4	7,723	179.74	44.2	1,344	85.39
Contra Costa	13.2	8,702	177.92	43.2	1,330	80.99
Santa Barbara	10.7	9,077	176.65	38.0	1,209	77.90
Sonoma	10.6	9,873	171.38	38.9	1,265	75.89
Fresno	14.7	7,842	168.11	40.1	1,266	74.30
Kern	11.9	7,717	160.97	35.0	1,267	68.40
Humboldt	12.2	7,798	151.02	41.6	1,196	65.49
Butte	11.1	8,783	129.84	38.2	1,103	57.38
Shasta	9.7	9,803	126.34	34.5	1,114	56.97
State average	16.9	9,126	220.33	43.6	1,354	89.35

Source: Western Insurance Information Service.
[a] Per thousand insured vehicles.
[b] Average per claim.
[c] Average premium income per insured auto.

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Table 5: Bodily Injury and Property Damage: Average Claims, Costs, and Premiums for Six Los Angeles County Cities in 1988

	Bodily Injury			Property Damage		
County	Claims[a]	Cost[b]	Premium[c]	Claims[a]	Cost[b]	Premium[c]
Beverly Hills	37.3	$13,608	$648.47	72.1	$1,733	$179.05
City of L.A.	35.8	10,690	454.23	56.2	1,513	140.17
Van Nuys	30.7	11,096	398.28	56.5	1,552	136.88
Compton	26.1	9,308	354.01	37.8	1,402	120.59
Pasadena	20.9	8,766	291.32	43.7	1,328	105.41
Long Beach	30.8	9,196	273.78	46.0	1,435	105.94
County Average	23.9	10,197	319.04	46.8	1,484	113.45
State Average[d]	16.9	9,126	220.33	43.6	1,354	89.35
State Average[e]	14.7	8,572	188.85	42.6	1,309	81.66

Source: Western Insurance Information Service.
[a] Per thousand insured vehicles.
[b] Average per claim.
[c] Average premium income per insured auto.
[d] Including Los Angeles County.
[e] Excluding Los Angeles County.

lated as a matter of statute law that there would be no changes in the right of plaintiffs to sue. Proposition 101, supported by some insurers, would have placed restrictions on litigation in auto tort cases and would have limited awards for pain and suffering. Proposition 104, promoted by most insurers, would have established a no-fault insurance system for auto accidents (as opposed to a tort or fault system) similar to that of New York.

In the push for insurance reform, insurers wanted to end or to reduce subsidies and to limit lawsuits and their costs, lawyers opposed no-fault insurance plans and limits to litigation, and legislators sought to turn the political heat on the insurance commissioner or the governor.

The ballot returns, combined with polling data, indicated that the voters did not trust either the insurers or the attorneys, and all these initiatives were easily defeated. Finally, Proposition 106 would have indirectly affected auto insurance by limiting the size of contingency fees earned by plaintiffs' attorneys. This initiative was defeated much more narrowly.

Proposition 103 was sponsored by "Voter Revolt," an organization headed by self-proclaimed consumer advocate Harvey Rosenfield. Rosenfield's campaign for Proposition 103, aided by high-profile support from Ralph Nader, was characterized by a display of crass dishonesty shameless even by California standards. Rosenfield argued that insurers' profits were unknown because their books were closed. In fact, insurers' books are quite open because insurers are required to file financial statements with the Securities and Exchange Commission and the California Department of Insurance. Rosenfield also argued simultaneously that insurance companies are both obscenely profitable and grossly inefficient. He made those assertions despite a wealth of accounting data indicating substantial losses on auto insurance operations. In fact, the California Department of Insurance calculated an accounting return on equity after taxes of only 3.3 percent in 1988 for the auto insurance business. Rosenfield's assertion about inefficiency was based on an apples-and-oranges comparison of overhead expenses between insurers and public utilities. The absence, however, of either massive entry into the California market by new firms or substantial takeover activity argues against the Voter Revolt's assertions.

Much has been made of income earned by insurers on investments made with premium income. A common argument is that insurers happily lose money on auto insurance itself, because they can make it up with investment income. It is also argued that increases in premiums cover the

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Dennis Renault, Sacramento Bee

"When are you going to recall this lemon you sold me, Ralph?"

losses arising from bad investments. These arguments are both inconsistent and incorrect. If income from insurance premiums is invested, then competitive pressures will force premiums down by the *expected*—not actual—income from the investments. Similarly, investment losses affect neither the demand (price) for nor the supply (marginal cost) of insurance. If a company tried to recoup investment losses by raising premiums, consumers would flee to competitors.

Rosenfield argued further that Proposition 103 would remove the insurers' "antitrust" exemption and thus implied that collusion had been a common practice sanctioned by law. In fact, collusion had been illegal for decades under the California insurance code. The main effect of the antitrust exemptions under the federal McCarran-Ferguson Act and under California state law was to protect the ability of the insurers to share actuarial loss data. This right was granted to allow small firms and new entrants to avoid the large fixed costs inherent in acquiring loss experience and thus enabled them to compete. Ironically, the removal of the antitrust exemption under state law will reduce the number of competitors. Moreover, it is difficult to see how an industry with 3,600 firms could collude successfully, especially as California insurance companies vary greatly in size, specialization, and other important factors.

The major provisions of Proposition 103, which apply not only to auto insurance but also to most property and casualty coverage, can be summarized as follows.

- Insurance premiums must be rolled back to levels 20 percent lower than those prevailing in November 1987, a year before the vote on the initiative. Thus, the actual rollback typically has been between 30 and 35 percent.
- The rollback provision applies to all insurers except those "substantially threatened with insolvency."
- The insurance commissioner must approve all rate increases.
- The insurance commissioner must be elected rather than appointed by the governor.
- "Good drivers" are entitled to an additional premium reduction of at least 20 percent. (As an aside, this provision in Proposition 103 was drafted so poorly that an individual with a conviction for drunk driving could have qualified as a "good driver." The legislature did summon sufficient courage to correct this particular problem.)
- The dominant rating criteria are to be the driving record of the insured, the number of miles driven annually, and the number of years of driving experience, in descending order of importance. Other rating criteria bearing a substantial relationship to the risk of loss can be adopted by Department of Insurance regulations, which must specify the weight given each rating factor.

Federal and state antitrust exemptions protected the insurers' ability to share actuarial loss data so that small firms and new entrants could compete.

As a practical political matter, the geographical location of the driver can be expected to be relegated to a minor or nonexistent role.

- The legal right of insurance companies under state law to share actuarial data is severely restricted.
- A publicly funded Consumer Advocacy Corporation is mandated to promote "the interests of consumers" in regulatory hearings. In addition, pri-

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vate intervenors promoting consumers' interests in regulatory hearings must be compensated by the Department of Insurance out of assessments paid by the insurers.

The rating criteria mandated by Proposition 103 would yield an enormous implicit subsidy from low-loss geographic areas to high-loss ones.

- Various tax provisions in the proposition maintain the insurance companies' tax liabilities, despite the mandated declines in their net revenues.
- Heavy civil and criminal penalties are imposed for "noncompliance."

Wealth Redistribution under Proposition 103. Politics is the art of redistribution, and the voting patterns on Proposition 103 reflect that clearly. While the public debate—as well as most of the media coverage—focused on the promised 20 percent rollback in premiums, by far the most important provision politically was the effective elimination of territorial rating as a major factor in determining premiums. By eliminating territorial rating, the rating criteria mandated by Proposition 103 would yield an enormous implicit subsidy from low-loss geographic areas to high-loss ones. Under strict implementation of Proposition 103's rating scheme, average premiums would fall in San Francisco County by about 1 percent, in Orange County by about 8 percent, and in Los Angeles County by over 21 percent. These three counties contain about 3.97 million insured autos. Of the other 55 counties in California—containing about 7.35 million cars—54 would face increases in average rates ranging from about 1.4 percent in Ventura County to almost 58 percent in Modoc County. The one exception is San Joaquin County, which under Proposition 103 would experience no change in average premiums.

It is instructive to review the county voting patterns on Proposition 103 shown in Table 6. Note that Proposition 103 passed statewide by a margin of 51.1 percent to 48.9 percent.

All three counties whose drivers could expect to be subsidized under Proposition 103 voted in favor of the initiative. Of the other 55 counties in the state, 54 of which stood to subsidize the three winners, five voted in favor of the proposition. These counties—Alameda, Marin, Santa Clara, San Mateo, and Santa Cruz—ranked 51st, 49th, 45th, 52nd, and 44th, respectively, among the "losers" in terms of the size of the increase in average premiums drivers there could expect under Proposition 103. The other 50 counties voted against the initiative, and there is a strong correlation between the size of the prospective increase in premiums and the proportion of the negative vote. In short, "Voter Revolt" is a misnomer; Rosenfield's organization might more accurately be named "Voter Civil War."

Forthcoming Problems of Regulatory Implementation

The insurers, unsurprisingly, sued to block implementation of Proposition 103 on a number of grounds. The central features of the California Supreme Court decision (*Calfarm Insurance Company et al.* v. *George Deukmejian et al.*) can be summarized as follows.

- The "substantially threatened with insolvency" standard for relief from the rate rollbacks is unconstitutional under both the federal and state due process clauses.

Table 6: Percent Changes in Premium and Voting Percent for Proposition 103: Selected Counties

County	Change in Average Premium	Percent for Proposition 103
Los Angeles	−21.4	62.8
Orange	−8.2	51.7
San Francisco	−0.9	65.2
Alameda	+8.0	58.9
Marin	+9.1	53.5
Santa Clara	+11.8	51.0
San Mateo	+12.6	52.8
Santa Cruz	+13.0	54.2
Ventura	+1.4	44.8
San Diego	+10.7	44.1
Monterey	+15.3	41.6
Sacramento	+16.0	39.3
Tulare	+23.3	28.7
Sutter	+37.1	32.3
Lassen	+46.5	29.9
Siskiyou	+49.8	29.9
Modoc	+57.6	23.2

Sources: California Department of Insurance and Office of the California Secretary of State.

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- Insurers are entitled to a "fair rate of return."
- Rate increases are subject to review by the insurance commissioner.
- The creation of the publicly funded Consumer Advocacy Corporation is unconstitutional.

To discern the implications of Proposition 103 as amended by the court, it is useful to begin with a few observations on the political climate within which the regulatory process will proceed. Since the insurance commissioner henceforth will be elected by popular vote, it is fair to assume that individuals espousing positions or handing down decisions construed as favoring the insurers—that is, allowing significant increases in premiums—will not enjoy long-lived political careers. The flavor of the campaign pledges now being made by the candidates for insurance commissioner reflect this. Conway Collis, Rosenfield's preferred candidate, believes that statements such as the following will yield electoral advantage: "If I'm elected Commissioner, I'm not going to be fair to the insurance industry. I'm not going to be reasonable. I'm not going to be even-handed. I'm going to break their backs. I'm going to be their worst nightmare come true" (*Los Angeles Times*, March 6, 1990). Another candidate, Ray Bourhis, boasts that he has "spent the last 17 years beating the insurance companies."

This political environment, combined with the court's requirement of a "fair rate of return," suggests that the developing system of insurance regulation in California is likely to display artificially low rates and concomitantly low-quality service, increased political tensions as a result of cross subsidies, higher costs, increased litigation, and an inefficient allocation of resources overall.

Artificially Low Rates and Lower Service Quality. The insurance commissioner is clearly expected to limit increases in premiums. As a result, the insurers will have increasingly strong incentives to degrade the quality of the insurance services they provide. Coverage limits will be frozen and will thus decline in real terms over time. Deductibles and other copayment features will increase. Insurers will take longer to pay claims. Certain kinds of policies will become unavailable, and certain classes of individuals will find it increasingly more difficult to find coverage. More generally, the heterogeneity of insurance services—that is, the range of options open to consumers—will decline, and consumers will be forced to invest more time and energy to search for policies with preferred characteristics. The true cost of insurance will rise inexorably.

Cross Subsidies and the Politicization of the Insurance Market. Rate decisions will also become ever more politicized as the cross subsidies inherent in Proposition 103 manifest themselves more clearly. Political pressures have already been brought to bear in a recent decision by Roxani Gillespie, the current insurance commissioner. Commissioner Gillespie determined that the rate increases required by Proposition 103 in rural areas are unacceptable, and she substituted a different pattern of cross subsidies that she finds more acceptable: "Our system gives Los Angeles County drivers the 20 percent rollback demanded by law. At the same time, it provides modest relief in Orange, Riverside, and San Francisco counties, while limiting rate increases in other areas to 4.5 percent. This is far better than the disastrous increases that would have occurred without it."

The developing system of insurance regulation in California is likely to lead to artificially low rates and low-quality service, increased political tensions as a result of cross subsidies, higher costs, increased litigation, and an inefficient allocation of resources overall.

Why should Los Angeles receive such blessings? Such rulings are certain to be challenged in court, both by insurers hurt by the rate rollbacks in Los Angeles and by drivers elsewhere demanding a different pattern of cross subsidies.

Higher Costs and a "Fair" Rate of Return. Once the game consists of determining a "fair" return, regulators cannot avoid arbitrary decisions about precisely what spending is eligible. Thus, the insurers and the commissioner will be thrust into debates about which costs are reasonable and which are not. For example, there is already political pressure to disallow political and charitable contributions, institutional advertising, and payments to affiliated firms from the costs on which insurers' "fair" returns are based.

While the debates continue about which costs are legitimate, the generally preferred approach

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of the consumerists for determining an acceptable rate of return is to rank firms according to their average costs, and then arbitrarily to pick some percentile as a standard above which costs would be deemed "excessive." This will tend to drive out firms with higher costs attributable to higher quality service, since quality is difficult to measure, and thus will reinforce the trend toward deteriorating quality. The consumerists blithely assume that cost differences are explained solely by relative efficiency. They ignore the cost differences that stem from differences in the quality of service provided.

Furthermore, under proposals for implementing Proposition 103, firms whose costs are lower than the standard will receive no reward for their relative "efficiency" because their allowed prices will be determined by their reported costs. Nor will these firms suffer any penalty should they allow their overall costs to rise toward the standard; their rates would also be allowed to rise.

Finally, as long as premiums are below competitive levels, insurers will have only weak incentives to scrutinize claims, because claims paid are a legitimate cost by any criterion, and so will have to be allowed in rate bases reviewed by the insurance commissioner. If firms receive no benefit from scrutinizing claims and suffer no penalty for paying them, the incentives both to file and to pay claims will increase. In short, the regulatory process established by Proposition 103 is likely to whipsaw consumers between declining quality and rising costs.

Increased Litigation. Litigation will be endemic. The insurance commissioner will have strong incentives to leave to the courts the onus of rate increases that, however justified by market conditions, will be politically unpopular. This was clearly the experience with requests for rate increases in the assigned risk program. Even at this early stage in the implementation of Proposition 103, the legal challenges to existing and anticipated rulings are destroying whole forests of paper. Moreover, to make the regulatory task merely Herculean in scope, many rulings will have to apply to all or most insurers despite the heterogeneity of the industry. This approach is certain to yield additional litigation, particularly as the court's decision in *Calfarm* mandates that insurers be given "an adequate method for obtaining individualized relief." As time marches on, it will become increasingly obvious that Proposition 103 ought to be called FEAFA—the Full Employment Act for Attorneys.

Inefficient Resource Allocation. The process of regulated insurance pricing put in motion by Proposition 103 will increasingly distort resource allocation. Regulatory ratemaking inevitably considers only costs and not demand conditions. Further, the cost data used for ratemaking will consist of accounting entries that reflect historical costs rather than economic (or opportunity) costs. As a result, average cost pricing will supplant marginal cost considerations. This process has in other similarly regulated industries consistently yielded rates that are excessively low. This will give new firms just entering the market, and unburdened by historical costs, a relative advantage. But such firms, by their nature, represent less security to consumers than do long-established insurers. Some of the new entrants will be fly-by-night firms, others will be insufficiently capitalized, and many may have weaker incentives than do established firms to preserve their reputations.

Firms whose costs are lower than the standard will receive no reward for their relative "efficiency" because their allowed prices will be determined by their reported costs.

Conclusions

During a hearing, California State Assemblywoman Cathie Wright asked Rosenfield about the origin of the 20 percent figure for the mandated rollbacks in Proposition 103. His answer? "It sounded good." Along with the agony now engulfing the insurance sector in California, that response should give pause to other states considering similar types of so-called consumerist regulation of insurance markets. The interests of consumers are served by maximizing the total value of the available basket of goods and services. Only competitive markets can yield that outcome; artificially low prices for a given good, whether or not combined with perverse regulation, are inconsistent with that goal.

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The interest of the "consumer" groups is far different: they enjoy few of the benefits yielded consumers by the operation of market forces, and they suffer few of the perverse consequences of the policy solutions that they espouse. Instead, the political power of the consumer groups—and the implicit payoffs yielded by such mechanisms as mandated payment for intervention in regulatory hearings—grow directly with the perversities created by expanding government power and inversely with the degree to which markets are allowed to operate to the benefit of consumers.

The California experience suggests that other states considering a similar path would do well to look skeptically at the assertions, promises, and, in particular, the hidden agendas of the purported consumer advocates. Moreover, if a competitive market is in some sense not working "well," it may be fruitful to examine other government policies as the likely source of the trouble. More generally, the travails of the California insurance market are illustrative of those awaiting the use of regulation as taxation, that is, as a means of resource allocation by government fiat. The urge to promote such regulatory mandates seems to have grown as the demands upon government budgets have expanded in both number and size. Federal and state decisionmakers ought to consider carefully the adverse effects lurking in the shadows should they succumb to such temptations.

The day after the California Supreme Court upheld most of Proposition 103, Paul Conrad, the clever but poorly informed editorial cartoonist for the *Los Angeles Times*, drew a California license plate reading, "WE WIN!" Sorry, Paul. We lost.

If the competitive market is not working well, it may be fruitful to examine other government policies as the likely source of trouble.

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The Government Securities Act of 1986

A Case Study of the Demand for Regulation

James B. Burnham

On October 28, 1986, President Ronald Reagan signed into law the Government Securities Act, bringing all dealers in the U.S. government securities market under federal regulation for the first time. Previously unregulated dealers now have to register with the government and comply with rules establishing minimum capital requirements, financial responsibility standards, and customer-safekeeping arrangements.

Why, in the sixth year of office, did a popular president committed to deregulation subject "the world's largest and most efficient securities market" (in the words of numerous government officials) to direct federal regulation? This essay addresses that question. While the answers may not come as a great surprise to long-time students of regulation, they do provide a graphic demonstration of how and why the pressure to regulate continues to find expression in federal legislation, even in instances where few measurable benefits can be demonstrated.

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Background

The Securities Act of 1934, which brought all significant private-sector stock and bond underwriting and trading under federal oversight, specifically exempted U.S. government securities from its key provisions. But the U.S. Treasury, as the issuer or guarantor of government securities, has had substantial power to shape the institutions and practices of that market. The Federal Reserve, as the Treasury's fiscal agent in dealing with the market, enjoys substantial powers. Other federal agencies have varying degrees of indirect control. For example, as participants in the dealer market, commercial and investment banks are subject to federal oversight through the various banking agencies and the SEC, and participants in the exchange-traded futures and options markets for government securities are subject to regulation by the Commodity Futures Trading Commission.

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For many years, however, a distinguishing characteristic of the U.S. government securities market was the substantial number of firms, some quite large, that were free from any formal government supervision since they dealt exclusively in U.S. government securities. This diverse dealer base, with no regulatory requirements for firms and individuals that wished to become dealers, clearly assisted the U.S. Treasury in its efforts to sell government debt at the lowest possible cost. With the rapid increase in the volume of government debt in the early 1980s, the number of firms active in this market increased substantially. By 1985 the number of unregistered firms was generally estimated at 200 to 300.

The Primary Dealers

At the center of the government securities market stand the roughly 40 primary dealers—those dealers with whom the Federal Reserve Bank of New York has a business relationship. Primary dealers, and those who aspire to become primary dealers, submit daily and monthly reports to the New York Fed and receive on-site inspections of their operations.

The New York Fed enters into substantial daily transactions with market participants. It acts as fiscal agent for the Treasury Department as well as for more than 100 foreign official institutions. In addition, monetary policy is conducted through transactions for its own account. In choosing with whom to do business, the Fed over the years has developed various criteria. Quite understandably, one of the most important of these focuses on the financial strength of the firm.

The Fed presumably would not deal with a financially unstable firm, and since the names of firms with which it deals are matters of public record, the public assumes that these primary dealers are "safe" firms. As a spokesman for the primary dealers conceded to Congress in June 1985, "We know that these primary dealers are being surveilled on a day-to-day basis by the Federal Reserve. The Fed is, in a sense, providing the credit check." The market perception of primary dealers' creditworthiness extends to a belief that the Federal Reserve would not permit a primary dealer to fail. In fact, the Fed has acted in the past to ease temporary financing difficulties for some of these firms.

The value of primary dealer designation is also confirmed by the primary dealers' exclusive access to real-time, video-screen-based information and trading systems provided by interdealer brokers. Transactions over these systems are agreed to "blind" without prior knowledge of the name of the counterparty. It is argued, therefore, that all those with access must have an unimpeachable credit standing, which is provided by the Fed's "primary dealer" designation.

The Storm Breaks

As the volume of U.S. government debt and guaranteed obligations swelled during the early 1980s, a number of government securities dealers developed problems. By 1985 there had been several well-publicized failures—most notably, Drysdale (1982), Lombard-Wall (1982), and Lion (1984). The losses associated with these failures were borne by commercial banks and a few public authorities, such as municipalities. The public felt few secondary repercussions, although the Federal Reserve did take steps in the Drysdale and Lombard-Wall affairs to minimize problems within the financial community.

For many years a distinguishing characteristic of the U.S. government securities market was the substantial number of firms that were free from any formal government supervision since they dealt exclusively in U.S. government securities. This diverse base enabled the Treasury to sell government debt at the lowest possible cost.

Securities dealers subject investors to the greatest risk with repurchase agreements, or "repos" in market terminology. Essentially, investors lend short-term money to dealers to finance their inventories of government securities. Investors are at risk if the value of the dealer's securities drops significantly (as a result of an increase in interest rates, for example), and wipes out the firm's capital. Investor risk is supposed to be controlled through agreements that identify each advance of funds with the purchase by the investor of a specific government security from the dealer and its subsequent repurchase at an agreed-upon date. An important variant on the repurchase agreement is the "reverse repo," in which the investor

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temporarily sells a security to a dealer in return for cash. If the amount of cash received is less than the value of the security, the cash borrowing is, in effect, overcollateralized.

While an ostensibly air-tight procedure, in practice a repurchase agreement has several weaknesses. It is relatively cumbersome and costly (especially for investments of only a few days or weeks) to transfer formally the securities involved from the dealer to the investor. Several other parties may also be involved in the process and numerous accounting entries required. Consequently, many dealers offer to provide "safekeeping" services for their investors, and simply send a receipt to the investor and point out that if third-party custody is required, it will reduce the net yield on the transaction.

The combination of rapid growth in the government securities market, yield-hungry investors in a period of falling interest rates, and careless investment practices by many participants had created conditions ripe for market disturbances.

Not surprisingly, such circumstances create temptations. For example, a firm might "sell" a security with a market value less than the customer's advance. It could use the same securities to secure more than one customer's funds or could even issue receipts without possessing any security. In the case of overcollateralized reverse repos, the dealer could sell the securities received to a third party for substantially more than he has advanced to the customer. Such temptations become particularly acute if a securities firm has incurred losses on its trading activities.

For large investors, the obvious defense against dishonest or unsound practices is to acquire solid information about the dealer, such as audited financial statements, length of time in business, and the reputation of the principals. Alternatively, investors could require delivery of the security and simply accept a lower yield. And, if the mechanics of this process are too costly, the investor could simply deposit his money at a bank. The lure of higher yields, however, has often been a deterrent to doing financial homework.

By early 1985, the combination of rapid growth in the government securities market, yield-hungry investors in a period of falling interest rates, and careless investment practices by many participants had created conditions ripe for market disturbances. Two such developments occurred in rapid succession in March and April. On March 4, 1985, ESM Government Securities failed, with potential losses for customers on the order of $300 million. It was followed by Bevill, Bresler & Schulman (BBS) on April 7, with indicated customer losses of $235 million.

The BBS failure was the less important of the two. BBS was an SEC-registered broker-dealer that conducted its government securities transactions through an unregistered affiliate. The firm had been investigated and censured by the SEC in 1980 for a variety of selling and trading rule infractions. BBS investors included savings and loans, commercial banks, and other dealers. Three smaller government securities firms also failed or were liquidated as a result of their exposures to BBS.

The ESM failure had a far more significant impact on the financial community. ESM was an unregistered dealer, although it was filing monthly reports (that turned out to contain false information) with the New York Fed. ESM's parent firm had also been investigated by the SEC shortly after it was established in 1977, but the investigation was dropped after four years as a "stale" case.

Most of ESM's repurchase agreement investors were city and county governments investing surplus funds. Subsequent investigations showed that ESM had been insolvent for some time before March 1985. With the complicity of a partner at its accounting firm and undisclosed "borrowings" from its investors, ESM managed to conceal its losses and negative net worth for an extended period. When one of its important customers began to have doubts and gradually withdrew its business, however, the coverup unravelled.

The failure of ESM precipitated the failure, four days later, of the Home State Savings Bank in Ohio. Home State, a $1.4 billion institution, had been borrowing heavily from ESM for years and used overcollateralized reverse repos to secure "cheap" funding. Without continued funding from ESM, Home State also collapsed. It is important to emphasize, however, that the collapse of ESM did not cause the failure of a healthy savings bank. Home State's heavy exposure to ESM was a symptom of its own underlying financial weakness. In fact, in 1983, the Ohio state examiner of Home State had described it as "a veritable time

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bomb," and Home State was probably also insolvent long before March 1985.

Home State's failure led, in turn, to the insolvency of Ohio's state-chartered savings banks' mutual deposit guarantee fund. Seventy state-chartered thrift institutions were temporarily closed. This generated sensational headlines in international financial newspapers and a short period of sharp fluctuations in the gold and foreign exchange markets.

Finally, ESM's failure led many customers of the smaller unregistered dealers to transfer their business to larger firms, particularly primary dealers. In June 1985 the SEC reported: "A number of commentators and panelists at the Commission's Open Forum [on the failures among securities dealers] noted that many investors have begun a 'flight to quality.' Some have chosen to deal only with dealers recognized as 'primary dealers' by the FRBNY, instead of making independent determinations of the capital adequacy and creditworthiness of dealers. Other investors have restricted their dealings to 'regulated' dealers, such as primary dealers, banks, and registered broker-dealers." While this fallout was not widely noted at the time, it would play an important role in precipitating passage of the Government Securities Act.

A Practical Exercise in Public Choice

Congressional hearings were held throughout 1985. The resulting record allows us to identify the positions of all the primary participants in the development of the Government Securities Act. It is useful in reviewing the debates over the proposed legislation to sort the various parties into one of five roles in the government securities market: the originators of securities, the customers, the dealers, the regulators, and to a lesser extent, elected officials. A rudimentary model of the demand for and supply of regulation can then predict the expected positions of the various players.

The originators (or sellers) of securities include the Treasury Department, government-sponsored agencies (chiefly involved in housing), and agents of the originators, such as mortgage bankers. In this public choice model those selling securities would be expected to oppose additional regulation, as it would tend to increase their borrowing costs. If regulation appeared unavoidable, the sellers of securities would want to play a major role in defining the new regulations.

The customers of government securities include all individuals and institutions that buy these securities, especially the Federal Reserve Bank of New York. The buyers of securities would be expected to have mixed reactions toward proposed regulation. Concerns about the possibility of less competition for their business and the possibility that regulation would encourage more intense dealer scrutiny of customer creditworthiness would lead to opposition, as the costs of transacting business would be increased. Offsetting these factors would be a reduced need for customers to monitor dealers' transactions to protect against fraud. Regardless of the positions taken by other customers, the New York Fed would want to remain unimpeded by the new regulation in controlling its business relationships with the primary dealers.

The failure of ESM precipitated the failure of the Home State Savings Bank in Ohio, which led to the insolvency of Ohio's state-chartered savings banks' mutual guarantee fund. Seventy state-chartered thrift institutions were temporarily closed.

Government securities dealers (or the middlemen) include commercial banks, SEC-registered dealer-brokers, and unregistered dealer-brokers. An equally important distinction is between primary dealers (New York Fed counterparties) and secondary dealers (all others). Already regulated dealers would be expected to favor regulation for their unregulated competitors, particularly if it imposed no new burdens on their own operations. Unregulated dealers would be expected to oppose a new oversight program unless they became convinced that profits would increase as regulation restricted new competitors.

The regulators in 1985 included the SEC, the FDIC, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Home Loan Bank Board. Regulators would be expected to be interested in expanding their turf. At a minimum they would insist that nothing be done to diminish their responsibilities.

Finally, elected officials would be interested in "doing something" if it would result in a net increase in votes or political campaign funds.

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Although this rudimentary model predicts reasonably well, it does not capture some specifics of the dynamics of the environment in 1985 and 1986. Until late 1985, Treasury officials attempted to stave off legislation. The department suggested that changes in its securities ownership record-keeping system ("book entry") could address many of the abuses uncovered in the repo market's safekeeping process. Meanwhile, Treasury officials worked to develop a fragile executive branch consensus that if Congress did enact legislation, Treasury should have the primary responsibility for developing any regulations.

Treasury's position was fully understandable. An increase of one-tenth of one percent (10 basis points) in the interest rates paid on Treasury securities would add $2.2 billion yearly to government borrowing costs. Thus, any increase in borrowing costs to Treasury would affect the federal budget with numbers large enough to catch the attention of Congress. Nonetheless, after it appeared that the House would pass legislation that would give rulemaking responsibility to a legislatively sanctioned self-regulatory organization, such as the National Association of Securities Dealers or Municipal Securities Rulemaking Board, Treasury changed its position. Treasury officials began to more actively support legislation that would put Treasury in control of any new regulations.

Stronger opposition to regulation, on grounds of its possible cost, came from the Department of Housing and Urban Development because of its concerns about the increased cost of issuing mortgage-backed securities. The Mortgage Bankers Association (MBA), speaking for a group heavily involved in originating government-backed mortgage securities, maintained that there was no need for additional legislation in view of existing regulatory authority and the market's capacity to self-adjust. If legislation were to be passed, however, the MBA wanted dealer regulation to be in the hands of the Federal Reserve rather than in a legislatively sanctioned self-regulatory organization or the Treasury. "An SRO," the MBA declared, "may cement in place the domination of the mortgage-backed securities market by a few large broker-dealers to the detriment of smaller firms." And if the Treasury were to have the regulatory authority, "it would be in a position to favor itself, disadvantage its competitors, and pressure its customers." In other words, the MBA feared direct Treasury borrowings would be favored over government-backed housing-related finance.

Until late 1985, Treasury officials attempted to stave off legislation by suggesting that its securities ownership record-keeping system could address many of the abuses uncovered in the repo market's safekeeping process.

From the Wall Street Journal, Cartoon Features Syndicate.

"You're under arrest for disturbing the peace!"

Government securities dealers generally preferred regulation. (An exception was Dillon Read, a large secondary dealer.) The majority of both registered and unregistered primary dealers accepted the principle of additional regulation and only expressed the desire that the Federal Reserve be the rulemaking authority. While this position is not surprising, the static rudimentary model of regulation fails to predict the strong views coming from the unregulated sector. The secondary dealer panel at the SEC's Open Forum on the failures among securities dealers strongly supported regulation. In testimony before the Subcommittee on Domestic Monetary Policy of the House Banking Committee, SEC Chairman John Shad reported that of all the dealer panels, "the secondary dealers were the most emphatic . . . in requesting regulation, because they feel they have been hurt more than others by the widely publicized fact that ESM and BBS were not regulated. . . . The secondary dealers feel they have sort of

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been tarred by this, and that regulation would increase investor confidence." Chairman Shad did not, however, take advantage of his appearance before the subcommittee to point out that in May 1985 an SEC-registered dealer had failed, with potential investor losses on the order of $16 million.

Despite the sizeable losses many investors had incurred, they were generally skeptical of regulation, as indicated in testimony by the Government Finance Officers Association, representing perhaps the largest single group of individuals directly affected. (Several city managers and finance directors were forced to resign as a result of their investments with ESM and BBS.) The association stated that "to preserve efficient money markets, . . . [it] encourages Congress and federal agencies to use restraint in adopting additional legislation and regulation." This polite manner of saying, "No, thank you," was elaborated on by an association official in testimony: "Government finance officers have experienced firsthand the inefficiencies that often result from well-intentioned but cumbersome legislation and regulation in the securities marketplace, and remain somewhat skeptical about the idea that regulation can preclude investment losses." The Government Finance Officers' position was not atypical. In testimony reporting positions taken at the SEC's Open Forum, Chairman Shad noted, "It surprised me that . . . [investors] were the least supportive of legislation. They were very critical."

The official executive branch position was, as noted, that Treasury should be in charge of any new rulemaking Congress deemed necessary. But the loose discipline of the executive branch over the SEC and Federal Reserve allowed these independent agencies to express somewhat different views to Congress. For them, the issue was not whether there should be regulation, but who should administer it. Neither agency wished to see Treasury in full control. Although the SEC (and numerous private-sector groups) wanted the Fed to be put in charge, the Fed itself was less interested in undertaking the task. The Fed did, however, want legislation to permit the New York Fed to continue to dominate the primary dealer oversight process. The Fed's position probably reflected its desire to avoid becoming ensnared in issues that might compromise its independence on monetary policy issues.

Elected officials uniformly supported legislation. The mayor of Beaumont, Texas, which thought it had $7.5 million of securities with ESM, put part of the blame for the city's loss on its outside auditors and called for federal regulation. Similarly, no member of the House or Senate questioned the need for legislation, despite the views of important investors, such as the government finance officers. Both Republicans and Democrats, particularly those from Ohio, Florida (headquarters of ESM), and New Jersey (home of BBS), warmly endorsed the final bill. Many supporters cited the failure of Home State and the ensuing collapse of the S&L deposit guaranty fund as the basis for their support.

Disagreement about the lead regulatory agency prevented final legislation from passing in 1985. The House passed a bill in late 1985 designating a self-regulatory organization as the rulemaking authority. The Senate bill, which emerged in the summer of 1986, provided for Federal Reserve oversight. But Treasury prevailed in the end, gaining rulemaking authority with an unusual "sunset" provision designed by a suspicious Congress to facilitate a review of Treasury's actions.

Despite the sizeable losses many investors had incurred, they were generally skeptical of regulation. Elected officials supported the legislation.

No recorded votes were taken on passage of the legislation in either house. The final version of the Government Securities Act was signed by Ronald Reagan in late October. Calling the act an important piece of legislation, he contended that the choice of Treasury as the rulemaker would minimize confusion and would help ensure that the federal debt would be financed at the lowest possible cost to the taxpayer.

Summing Up

The Government Securities Act of 1986 is a classic product of two traditional sources of the demand for regulation—business firms and politicians. Unregistered secondary security dealers were losing customers to large registered firms and primary dealers who achieved their "safe" status as a result of their acceptance by the New York Fed as suitable counterparties. Although the direct influence of the unregistered dealers is difficult to measure, clearly they were interested in acquiring a federally registered status.

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Politicians, meanwhile, felt obliged to respond to events that had occurred within their districts. Although the Ohio, Florida, and New Jersey delegations probably felt the most pressure, the BBS and ESM failures caused nationwide losses, particularly for municipal governments. In addition, the failure of Home State seriously muddied the issue. The plight of 70,000 Ohioans temporarily denied access to their savings deposits established an erroneous association between the problems of the thrift industry (which would surface with a vengeance several years later) and those of the government securities market. Largely undeservedly, oversight of the government securities market became a consumer protection or "widows and orphans" issue.

The supposed beneficiaries of the act, the professional investors, were either lukewarm or opposed to the legislation. But their views were muted in the final legislative process, in part because Treasury, the party that would end up paying most of the added costs, was never willing to spend large amounts of political capital to oppose the legislation. (A major tax reform bill, also moving through Congress in 1986, was the chief legislative concern of Treasury at the time.)

In the final analysis, the ease with which the Government Securities Act was adopted (once the regulatory turf war was settled) may reflect an acceptance of the inevitable by many of the parties. With the exception of the foreign exchange and commercial paper markets, the government securities market was the last major financial sector to remain unregulated. A number of dealer witnesses pointed out that they already faced extensive oversight in their corporate stock and bond activities and in municipal securities underwriting and trading, so that they had no strong business objections to the regulation of yet another market.

At the same time, legislators sought to supply a federal response to the problems of the savings and loans in Ohio. The popular linkage between the failure of ESM and the problems in Ohio made passage of the act a visible response that voters and campaign contributors (perhaps including dealers desirous of regulation) could appreciate. And in states and communities where the ESM and BBS failures had resulted in investment losses for local governments, incumbent politicians who voted for the act armed themselves against challengers who might ask, "What did you do about this mess?"

The ease with which the Government Securities Act was adopted may reflect an acceptance of the inevitable by many of the parties. Passage of the act is compelling evidence that the underlying sentiment for government regulation is alive and well.

The Government Securities Act is compelling evidence that the underlying sentiment for federal regulation is alive and well. Elected politicians continue to find that the presumption of federal legislative responses to crises is helpful to their careers. Business interests, faced with vanishing customers, still seek federal intervention. In the case of this act, these behavioral patterns were reinforced by the already extensive formal federal regulation of the securities markets and the quasi-regulated nature of the primary dealers.

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Readings

Competition Meets Telecommunications Regulation

Changing the Rules: Technological Change, International Competition, and Regulation in Communications
edited by Robert W. Crandall
and Kenneth Flamm
(The Brookings Institution, 1989), 424 pp.

Reviewed by John T. Wenders

The U.S. telecommunications industry can best be described as a regulatory cartel in which a balance of interests was struck. The industry, long dominated by the Bell System, got regulation that assured its profitability and largely protected it from competition and the antitrust laws. The politicians and regulators got a toll (long distance)-to-local subsidy that benefitted their strongest political constituency—residential subscribers.

This balance of interests was politically efficient because it maximized the vote-getting that drives the political-regulatory mechanism. But it was very economically inefficient and resulted in greatly overpriced toll usage and perverse incentives. Inevitably, market forces began to tear it apart.

This volume of essays, the result of a conference at the Brookings Institution in 1987, provides an excellent discussion and many data on the recent history and status of the telecommunications industry. As the volume well illustrates, the major remaining inefficiencies and competitive barriers are still regulatory and political. The major weakness of this book is its lack of any substantive analysis of how the political-economic mechanism works in this industry, so that there are few realistic suggestions about how the existing structure might be altered to produce a more efficient outcome. How can we change, at the margin, the balance of interests that produces the still inefficient outcome?

The quality of the papers in the volume is uniformly very high, and they are accessible to the general reader. The three key essays, comprising 50 percent of the volume, are by Kenneth Flamm on technological change, by Robert W. Crandall on the local operating companies, and by Leonard Waverman on U.S. toll competition.

Flamm's essay documents in detail the rapid technological change that has driven transmission (primarily) and switching costs down in the postwar era. Technological advances have reduced the cost of providing toll relative to local services and have unleashed market forces creating pressures for corresponding price changes. Thus, the struggle for the overpriced toll market continues today. As Flamm argues, however, compared with the unregulated computer industry, these technological changes were implemented slowly. He also argues that "communications hardware costs dropped much less rapidly than those of computers" and points out that switching prices fell sharply only after the AT&T divestiture. He concludes that the perverse incentives of rate-of-return regulation were responsible for both the slowed introduction of new technology and the toll market's higher than competitive prices.

Waverman's analysis of the toll market accepts the notion that natural monopoly—the existence of economies of scale and scope—is a legitimate reason to regulate. He then shows that such conditions do not exist in the market and concludes that the toll market is largely competitive. Waverman is right on both scores, but searching for proof in cost data is a fruitless exercise. Data generated by regulated monopolies probably has little relationship to the cost structure that would occur under open competition. Natural monopoly cost conditions might be found simply because the market was regulated as a monopoly.

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Further, natural monopoly theory fails to provide a credible reason for real-world regulation because it presumes perfect regulation to carry out its idealistic prescriptions, but perfect regulation does not exist in this or any other industry.

Crandall focuses his analysis on the question of whether the divested Bell operating companies (BOCs) should continue to be prevented by the Modification of Final Judgement (MFJ) from integrating forward into long-distance markets or backward into equipment and information services. As the Department of Justice initially held —before it got cold feet—in the triennial review of the MFJ, Crandall concludes that the line-of-business restrictions on the BOCs should be kept in place until the states adopt alternatives to protective cost-based local rate-of-return regulation. (Do not hold your breath.) Crandall finds that the old integrated AT&T probably did use its control of the local operating companies to prevent entry into toll and terminal equipment markets and that it did favor Western Electric as a supplier. But he also concludes that the alleged subsidization of competitive services by regulated markets was unlikely. The old Bell System's foreclosures of outside competitors are probably irrelevant in debates on the proper range of activities for the divested BOCs. The equal access system is in place, and the terminal equipment market has been completely deregulated. Potential problems remain if the BOCs are allowed to integrate backward into equipment manufacturing, but these difficulties result from the perverse incentives created by local rate-of-return regulation. Crandall's finding that AT&T did not engage in cross subsidization of its competitive operations is not surprising since the whole political thrust of regulation was just the opposite—to use revenues from the various toll markets where the political constituency was weak to subsidize local markets, especially residential service, where the political constituency was much stronger.

As Crandall points out, by far the largest economic distortions in the industry result from the continued overpricing of toll services. These pricing policies arise from the politically motivated allocation of local accounting costs to the local access services needed by the retail toll carriers. Thus, Crandall's (and Waverman's) proposals to improve competition in the retail toll market will have little effect on efficiency there because the major source of inefficient toll pricing is the overpricing of local access. As long as this is controlled by the regulatory process, no amount of massaging of the competitive conditions in the retail toll market will amount to much.

Aside from the very useful and nontechnical descriptions of much of the recent history of the industry, Flamm's, Waverman's, and Crandall's essays also contain many useful data on costs, prices, and market shares.

This volume also includes interesting and competent reviews of international telecommunications generally (Eli Noam), Japan (Tsuruhiko Nambu, Kazuyuki Suzuki, and Tetsushi Honda), the developing countries (Ashoka Mody), technical standards (Stanley M. Besen and Garth Saloner), national security (Ashton B. Carter), and the technical growth of the telecommunications and computer industries (Nestor E. Terleckyj). An essay on the situation in the United Kingdom, where the same problems were tackled in a different way, could have been useful.

The striking feature on the international scene is the remarkable similarity across countries of the general thrust of both regulation and market forces. In general, regulation produced an overpricing of toll and international services for the benefit of local (and postal!) service, a resistance to technological change, heavy-handed protection of the incumbent monopoly carriers, and the inevitable gnawing of market forces for reform wherever service was overpriced or otherwise restricted. Apparently the laws of both the political and economic markets work much the same in all democracies.

Whatever our complaints about the distortions created by regulation in the United States, we can take some consolation from the fact that it was usually much worse in the rest of the world, where outright government ownership often prevailed. Imagine what U.S. telecommunications would be like if—as in most of the West—they were run by the Postal Service! For years, as Flamm's essay points out, the Bell System led the world in introducing new technology, and the United States has been at the forefront of liberalization and deregulation. Only the United Kingdom and Japan have made similar efforts. While the United States still has a way to go, especially in severing decisionmaking from politics and opening up the local markets, overall the U.S. telecommunications service is the best in the world.

Still political-regulatory forces do not reform themselves. The progress made by the FCC and, inadvertantly, by antitrust enforcement has been bitterly opposed by political forces and state regulators. A new short-run balance of economic and

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political forces has been reached. But the ball is still squarely in the political arena as various regulatory commissions, Congress, and Judge Greene continue to define the rules of the game establishing the competitive and noncompetitive environments. Activity is now dominated by self-interested jockeying and rent-seeking. Most of the disinterested policy recommendations in opposition to further liberalization are based on either the spectre of what the BOCs could do by acting irrationally, for example by cross subsidizing, or what they might do because of the perverse incentives of state regulation, for example by gold-plating the rate base. Public policy is also hampered by the tendency to use introspective tests, which need information that is largely unknowable, rather than to have faith in market processes, where the information actually is, to sort out matters. Further progress will come about only by the inevitable work of the market as it seeks out every niche where regulation has produced uncompetitive results.

Applying the Double Standard

Japan's Unequal Trade
by Edward J. Lincoln
(Brookings Institution, 1990), 164 pp.

Reviewed by William A. Niskanen

One might hope that a responsible policy institute would provide some balance to the inflamed rhetoric about Japan's trade practices. Unfortunately, this book by Edward J. Lincoln, a senior fellow in the foreign policy studies program at the Brookings Institution, does not provide that balance.

Lincoln acknowledges that Japan has lower tariffs and fewer quantitative restraints on manufactured imports than that of any other major nation, including the United States. Moreover, he recognizes that trade balances are primarily determined by macroeconomic conditions and are not much affected by trade policies. And he favors the liberal trade principles embodied in the GATT over a system of managed trade.

Nevertheless, Lincoln concludes that the U.S.

"HERE'S YER PROBLEM—THIS HERE LITTLE JAPANESE DOO-DAD IS BLOCKING YER TRADE FLOW!"

government should continue to pressure Japan to change those domestic government and business practices that may limit its import of manufactured products. He makes three arguments for this conclusion:

- Japan is now an economic superpower, and a failure to change its trade patterns may undermine the world trading system.
- U.S. trade pressure and more open Japanese markets may be necessary to maintain our mutual security relations.
- Japan's policy of protecting emerging high-technology industries gives the Japanese an advantage in international competition.

But Lincoln applies a double standard. A similar case has been made that the newly aggressive U.S. trade policy is the major threat to the world trading system and our mutual security relations. And there is no consistent pattern that indicates that protection of infant industries leads to increased international competitiveness.

Japan *is* different. Most of Lincoln's book is an attempt to demonstrate that the differences in Japanese trade patterns reflect a system of implicit protection. One chapter reviews the numerous studies that attempt to explain Japan's unusually low rate of manufactured imports. Most of this difference is explained by the same conditions that explain the rate of manufactured imports in other countries. Whether the Japanese rate reflects implicit protection depends on such technical issues as whether one should control for the distance to major markets. One chapter documents Japan's unusually low rate of intraindustry trade. One chapter summarizes Japan's major unusual domestic policies and business practices, both of which Lincoln describes as "distorted." And another chapter describes the

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many dimensions in which Japan is changing rapidly. In this regard he should have mentioned that Japan is becoming especially open to U.S. exports. The Japanese share of U.S. merchandise exports, for example, increased from about 9 percent of total U.S. exports in 1980 to over 12 percent in 1989.

Lincoln concludes that continued U.S. pressure on Japan is justified by the observation that "its current behavior remains at odds with the pattern of other industrial nations." He may not appreciate the irony that the focus of the initial Super 301 charges was on three Japanese practices that are quite similar to those affecting the same industries in the United States. He is wrong in concluding that "overwhelming evidence proved that [the 1986 semiconductor agreement] was not being implemented"; the U.S. government never released the evidence on which it based the charge of third-country dumping, and the basic agreement did not commit Japan to purchasing a specific share of semiconductors from imports. He appears not to understand that U.S. trade policy is now the primary threat to the GATT. For nearly 40 years, under U.S. leadership, the industrial countries developed a system of mutually agreed rules about allowable trade practices and a common dispute-settlement process. In recent years, however, the U.S. government has increasingly resorted to unilateral pressure to change the domestic practices of other nations that may limit our exports, even when such practices are wholly consistent with GATT rules. Japan has been the special target of this pressure, but we are all its victims. This reviewer is saddened by yet another academic rationalization of the unilateral bullying that has become the dominant tactic of U.S. trade policy.

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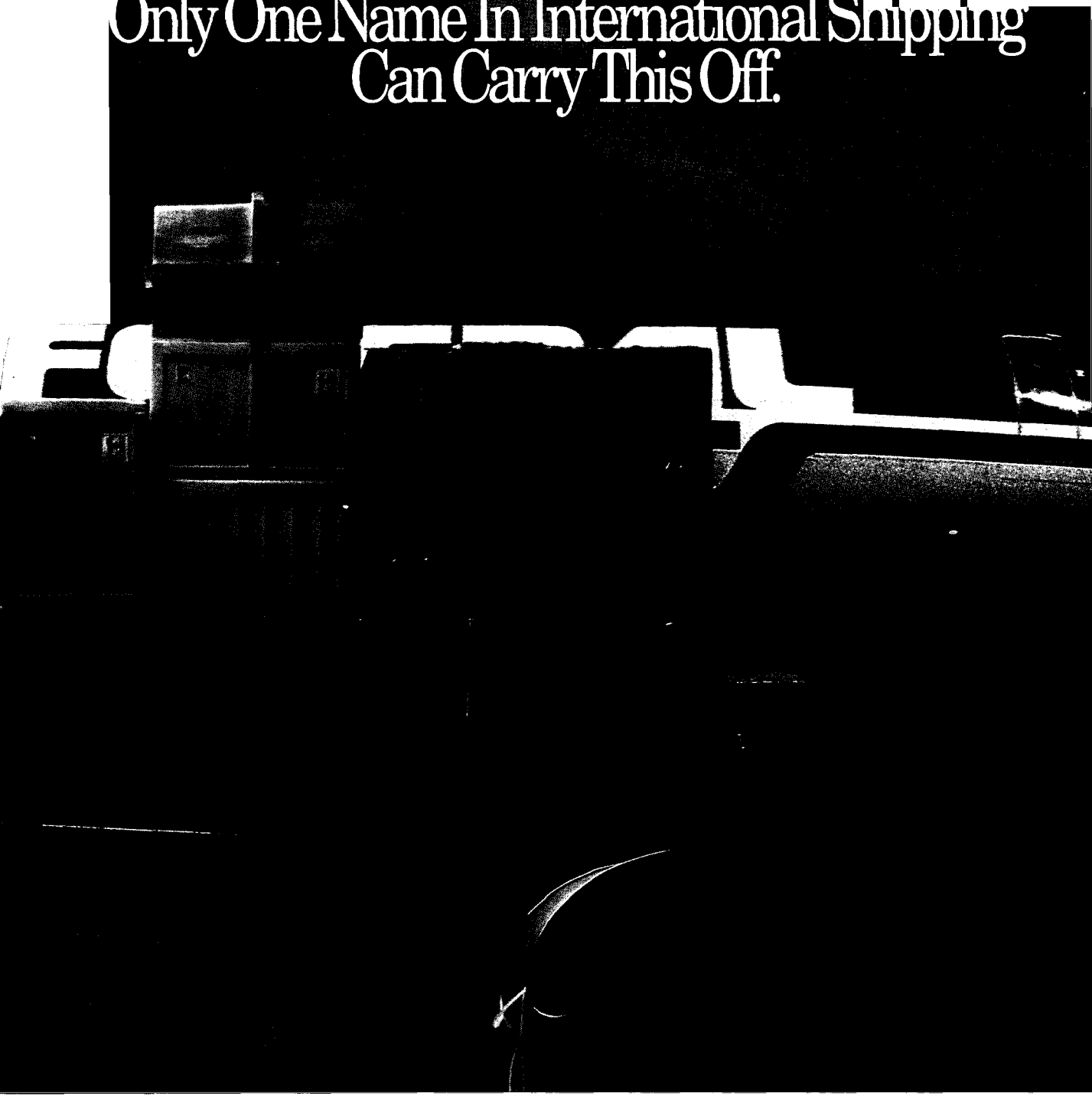

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